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Saving EMU

Central funding of public deficits, combined with a renewed Stability and Growth Pact, can stabilize the eurozone

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By Wim Boonstra[1]

Introduction

The euro is under serious pressure. Although in the early months of the financial crisis of 2008 the euro has served EMU's member states very well, there are increasing doubts about its survival in the long run (Smalwood, 2010). These doubts are due to a series of financial crises that, starting with Greece, has erupted in the eurozone during 2010. These crises have illuminated the fact that EMU is badly prepared to deal with serious budgetary problems in some of its member states. There is speculation that the eurozone should shrink its membership base (Münchau, 2010; Featherstone, 2011). Recent developments are proposals, made early March 2010 by German finance minister Schäuble, to establish a European Monetary Fund (EMF) or the issuance of so-called 'eurobonds' to help weaker countries to finance their budget deficits. The summer of 2010 saw the arrival of the European Financial Stability Facility (EFSF) (for details on the support measures see Alcidi et.al., 2010). Moreover, during 2010 the European Central Bank (ECB) has purchased substantial amounts of government bonds of member states with weaker fiscal positions. However, although these interventions underlined the strong political commitment towards EMU, they have not succeeded in calming the markets.

One of the fundamental and unsolved problems of EMU is the fact that the issuance of government bonds is fragmented along national borders. This has several consequences. First, it gives markets, once they lose confidence in a country, the opportunity to create an acute liquidity crisis. It may be expected that, as long as markets are fragmented, the euro will remain sensitive to such bouts of speculation. Second, there is the problem that financial markets for most of the euro's lifetime have completely failed to differentiate between high and low quality sovereign bonds. For example, before 'Lehman', Italy and Greece paid more or less the same interest rate as Germany and the Netherlands (figure 1). In combination with the failure of the Stability and Growth Pact (SGP) to discipline national fiscal policies, public finances in several member states of EMU have gradually deteriorated since entering EMU[2]. Third, this fragmentation of markets and their relative illiquidity in itself brings unnecessary costs for EMU's member states.

This article presents a proposal aimed at helping to advance European financial integration. Specifically, it advocates central funding of all 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 spread mechanism is put in place to tighten the budgetary discipline of participating countries and to prevent 'free riding' of financially weaker countries on the creditworthiness of the stronger countries to occur. In order to do this, it is proposed to establish a central agency, whose central task would be to organize this central funding and apply the spread mechanism. This agency, hereafter called the EMU Fund, would also be the best placed institution to

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[2] The failure of the SGP should not have come as a surprise (Winkler, 1999; Buiter, 2005);

fulfil the tasks of the envisaged EMF (Boonstra, 2005). In doing this it also helps to liberate the ECB from intervening in the government bond market in order to enhance liquidity of debt instruments issued by the weaker countries.
The proposal presented here comes against the background of a series of recent ideas to issue so-called 'eurobonds' by several authors (see i.e. De Grauwe, 2009; Mayer, 2009; Nausschnig, 2009, Delpla, 2010). These new 'eurobonds', not to be confused by the traditional Eurobonds that have been issued by governments and countries alike for decades, serve to support the weaker countries. The pros and cons of these issues are discussed in ELEC (2010), and it appears that strong resistance comes from German authors (Issing 2009; Kösters 2009). Especially the 'free ride' that common Eurobonds would offer weaker countries and the moral hazard that originates from it are rejected by the Germans. Alcidi et. al. (2010) offers a good overview of a number of proposals and their technicalities. All in all, they are valuable contributions to the solution of EMU's vulnerabilities. However, although there are many differences between them, they all have one aspect in common: they leave the national government bond markets (and thus the fragmentation of EMU's government bond markets) more or less intact. No one suggests to replace all national markets by a central funding of all of EMU's fiscal deficit via a central agency. The idea presented in this article, although it builds on an older idea than the other proposals, goes further in consolidating the eurozone by removing a very important source of the eurozone's vulnerability: the fragmentation of its government bond markets (Boonstra,1991, 2005). By adding a margin mechanism in order to discipline policy makers, it fundamentally strengthens EMU.

Background

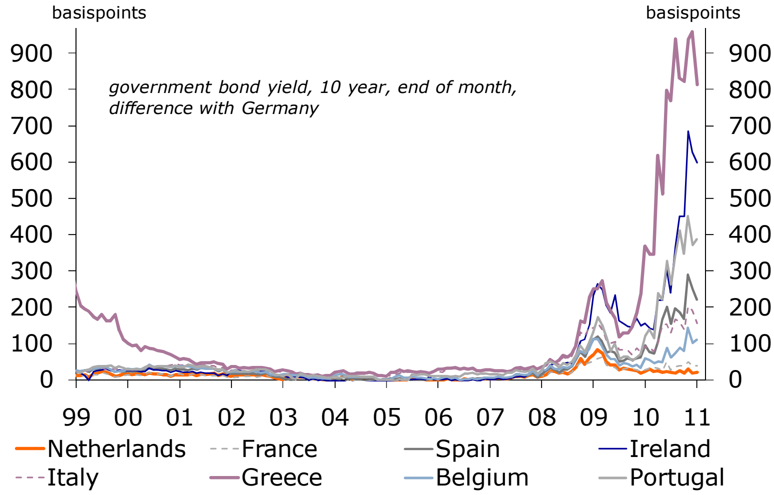
Since its introduction in the financial markets in 1999, the euro has increasingly earned its place as the world's number two currency. Although the euro can be considered as a major success, it still has its weaknesses. Those weaknesses originate from the incomplete status of the European financial integration.
This incomplete status can be summarized as follows. Although the money markets within EMU are fully integrated, exchange rate risks have disappeared and the ECB has turned out to be an effective central bank, public bond markets remain fragmented along national borders. This makes EMU vulnerable. Whereas in the past, before the introduction of the euro, financial markets could speculate against the currencies that participated in the Exchange Rate Mechanism (ERM) of the European Monetary System (EMS), this possibility today has vanished due to the disappearance of the national currencies. However, financial markets can still speculate against individual member states of the EMU by driving up interest rates of the national government bonds to levels that poses challenges to a country's debt sustainability (Featherstone, 2011). In the most extreme case, when market participants shun a particular country's sovereign debt, the government in question will no longer be able to roll-over its existing debt. This will force the country into an acute liquidity crisis. This has happened to a large extend in Greece and is threatening Ireland when it became clear that these countries' public finances are in a very poor shape, and it is still a potential threat to countries like Portugal, Spain and possibly even Belgium.

The sensitivity of EMU's financial markets for the various public deficits is a relatively new phenomenon. This is because the deterioration of fiscal positions within EMU did not translate into higher bond spreads until the global financial crisis. After the introduction of the euro, bond yields converged to the lowest (German) level (figure 1). It seems that financial markets either denied the existence of sovereign risk, or denied the no-bail out clause of the Maastricht Treaty[3]. During this period, markets did not exert

[3] The expectation that the no-bail out clause will not be effective in times of crisis appeared to be correct in the Greek case.

any discipline on governments to put their public finances in order. This fact appears to be forgotten in the recent discussion about the issue of 'eurobonds' to help the weaker member states through the current crisis. Any initiative should not only help the countries with weak public finances, but also restore the functioning of financial markets in normal times. The current crisis illustrates how vulnerable the public finances of many countries still are.

Figure 1: Bond spreads within the eurozone



Source: EcoWin

Since the start of the crisis in the summer of 2007, and even more pronounced since the collapse of Lehman Brothers in September 2008, risk has a price again, and one that is much higher than debtors were used to in the past. After October 2008, when governments around the world had to intervene in order to avert a total meltdown of their financial systems, public finances deteriorated sharply. Public debt in most countries in the eurozone rose steeply since the last quarter of 2008 due to the various banking bailout operations, the expansionary government measures and the costs of the recession. This will leave its traces in public debt ratios for many more years to come (Kamalodin, 2010). Spreads within the eurozone increased strongly, to levels which made investors worry about the pure existence of the euro.

Could it be possible that countries were forced out of the EMU? Some speculated that it would even be a good thing if countries with weak public finances would leave the eurozone (Kösters, 2009; Smallwood, 2010). These, of course, are dangerous thoughts, because if one country would have to leave EMU, market participants would ask themselves: 'who's next?'.

Risk awareness, so long absent in EMU's bond markets, seem to be back with a vengeance. It remains to be seen, however, whether the current 'post-Lehman' situation, in which markets sharply differentiate between the various qualities of public debt within EMU, will permanently stay with us or not. Given the short memories of market participants it cannot be excluded that the future will bring us the return of a situation of non-discriminatory markets as described above.

In reaction to the acute problems of some countries, it is not surprising that a series of initiatives were launched to help the weaker countries. Even less surprising is that Germany, having seen that these weaker countries had a free ride for almost a decade on German creditworthiness and did not put their public finances (and competitive positions) in order, is not very enthusiastic about bail-out proposals.

On the contrary, it seems to welcome the increase in risk awareness in the markets. This should have happened much earlier, appears to be the line of reasoning in Germany (Issing, 1999; Kösters, 1999). It should be noticed that both the poor functioning of markets during 'normal' times and the sudden swings in sentiment in crisis times have a negative impact for the stability of the eurozone. Seen against the German aversion to financial support for weaker countries, the establishment of a European Financial Stability Facility (EFSF) is a positive move forward

How to fundamentally strengthen the euro.

To be viable in the long run, the EMU should be strengthened in a way that:

1) Improves (or replaces) the disciplinary forces of markets;
2) Improves fiscal discipline in the member states;
3) Takes away the possibility of financial markets to speculate against EMU and the euro's existence;
4) Shelters countries from sudden large swings in market sentiment;
5) Offers benefits for both the weaker and the stronger member states.

Only when the benefits for all countries, both with strong and with weaker public finances are clear, a substantial institutional reform of EMU may be expected. If not, no substantial changes may be expected and EMU will remain an only half-finished project, with always the probability that sudden problems or changes in sentiment will disrupt EMU and even endanger its survival.

The strong market reaction to the events in Greece and Ireland again underlines the potential vulnerability of the euro. Even today some observers still 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 decide to revert to a national currency.

The Maastricht Treaty and the later amendments 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. Therefore, the consequences are very serious. However, it goes beyond the scope of this paper to go deeply into the consequences of EMU break-up. [4]

History demonstrates that many attempts to realise monetary unions between countries fail. A good example is what is known as the silver-based Latin Monetary Union, which commenced in 1865 and functioned well for some years, but fell apart several years later when Europe went over to the Gold Standard. Like EMU, the LMU was a monetary union created between politically independent states that did not give up political and fiscal sovereignty to a central authority (Kindleberger (1993), pp. 68 – 70). The difference between the LMU and EMU, however, are striking. There was no central bank with a single monetary policy and no single currency. It never reached the degree of monetary integration that EMU has brought.

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

[4] See Cliffe (2010), Boonstra (2010) and Alcidi et.al. (2010) for several scenarios. For example, the effects of a weak country like Greece leaving the eurozone would be huge, not only for Greece itself but also for the rest of the eurozone. Important transmission channels are the effect of the quality of Greek private sector debt (that would acutely deteriorate in quality as well), the losses to be taken by banks and investors on their holdings of Greek public debt (that would seriously threaten financial stability in the eurozone) and the increasing fear that the euro might fall apart completely (which will lead to higher risk premiums demanded by investors on most euro denominated debt).

periods with fragmented currency areas. Almost every national currency of the present is itself a result of processes of monetary integration of the past.

But as far as is known, it has not proved possible in the past to create a viable monetary union of countries that are similar in size with a shared currency and equally shared monetary policy, but without political unification. However, virtually every successful innovation has followed a trail of failures. There is no objective reason why the euro could not be another successful innovation. Its monetary arrangements are well-designed and so far it has proven to be a successful currency.

As said, European integration is not finished. Although monetary integration of EMU is complete, political and fiscal integration of Europe has still a long way to go. As long as speculation about its demise will occasionally pop-up, the euro will be relatively vulnerable. 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 experienced.

A major intensification of European cooperation and institutional 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.[5] 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 the creation of a pan-EMU bond market. See Alcici et.al. (2010) for an overview of recent proposals. Although the creation of these facilities will certainly strengthen the euro bond market, this new market segment would either still remain small compared to most national public bond markets and still not solve the problem of market failures in normal times. Moreover, the public bond market within EMU, already too fragmented, would see just another public bond issuer. Fragmentation would further increase.

Central funding of public deficits in the EMU: introducing the EMU Fund

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. Central funding of public deficits can deliver this and would mean a fundamental step forward in European integration. 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 their public deficits are funded. This means, specifically, that they must impose a number

[5] Münchau (2010) comes to the conclusion that this option is essential for the eurozone to survive in its current size. The current design, according to his vision, is only workable for a smaller EMU, consisting of countries that are more similar in economic development and political attitudes than the current 16 members. Note, however, that the establishment of the EFSF and the issue of so-called 'eurobonds'are a major steps in this direction, albeit it remains a half-way solution.

of restrictions on themselves with regard to the funding of the deficit. The arrangements to be agreed upon are as follows:

1. Government deficits must from now on only be funded by the intervention of a new central funding institution to be created. This institution is the EMU Fund. This means that government debtors may no longer directly turn to the capital market or private lenders.
2. Monetary financing of public deficits is not allowed. This rule was already laid down and endorsed by all member states in the Maastricht Treaty.
3. The 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 is determined by reference to the relative financial health of a member state. To be more precise: the margin is based on the deficit and debt performance. The performance of the individual countries is always being measured against the average of the debt and deficit of France and Germany.
5. As the creditworthiness of EMU ultimately depend on France and Germany, it is proposed that those two countries by definition never pay a margin. Countries that perform better than France and Germany also pay no margin. They benefit from the improved liquidity (see below). Only countries that perform worse than the French/German average pay a margin to the EMU fund.
6. As a result, the EMU Fund will always have a positive operational result. This will be added to its equity, giving it a buffer for problematic situations.
7. Countries that break the rules – that for example start with monetary financing, fail to pay their spread or directly approach financial markets for funding- 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. This part of the proposals comes close to the German EMF-proposal.

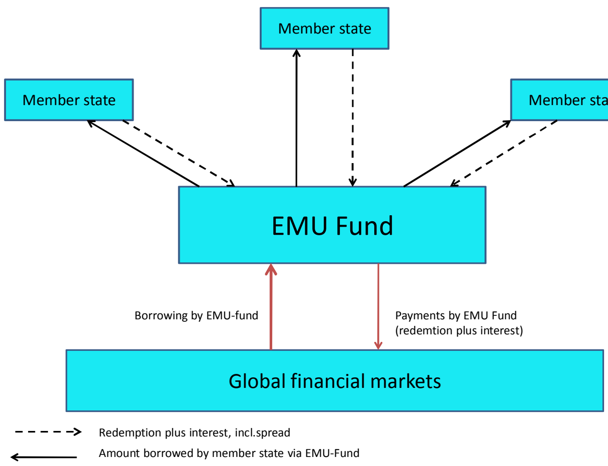
Advantages of the EMU fund

Establishing the EMU fund as outlined offers a number of evident advantages, for both fiscal policy within EMU and for the effectiveness of the European financial markets. Above all, it shelters its member states from sudden swings in sentiments on the financial markets. Moreover, the fund can be introduced without significantly affecting the far-reaching autonomy in budgetary policy that the member states currently possess. The EMU Fund could also be used as an additional way of strengthening budgetary discipline, because by adding effective sanctions that do not comply with the rules, it substantially strengthens the existing SGP (Boonstra, 2005).

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 zero interest margin. It would for once and all end the possibility for policymakers to ‘benefit’ from a lack of market discipline. The marginal costs of bad economic policies 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 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 paying a lower margin 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.

Figure 2: Structure of EMU Fund



The EMU fund will soon by far be the most important issuer of Eurobonds, dwarfing all the national public bond markets and the market for its bonds will be a full-blown competitor for US Treasuries.. Therefore, it 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 better able than the German Bund to support a large derivatives market, without the risk of illiquidity in times of strain.[6] The emission volume of the new fund will soon be comparable with 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.

Drawbacks of the EMU fund approach

This approach also involves some drawbacks. The most important of these come down to the problems in objectively setting the margins used by the EMU fund in its lending to the various national

[6] 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.

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.

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 average for French and German 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.

Obviously, variables can be added to this equation, such as the level of public investment or the share of the public sector in the economy. For sake of transparency, however, it would be a good thing to keep the formula as simple as possible. Moreover, the attraction of the variables selected here is that they do 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. However, this brings the danger of political discussions about the degree of accurateness of these forecasts. Therefore, it seems best to stick to as 'hard' figures as possible. The Greek case teaches us that, in addition to national central banks, also national statistical offices should be politically independent. Eurostat should play a supervisory role in this field.

The coefficients α and β will have to be set in advance. Setting these coefficients inevitably involves an element of arbitrary judgement, in which political considerations will also play a part. The key questions are, naturally, how sensitive one wishes to make the system to relative performance of the participating countries and which relative weight should be put on past performance (public debt ratio) and current performance (public deficit ratio).

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 no more or less arbitrary than the current ceilings deriving from the Maastricht Treaty and the Stability and Growth Pact or the conditions attached to the current range of *ad hoc* rescue operations. The good news is that once the parameters have been set the rest is a matter of straightforward calculation and the margins are automatically calculated. The system is completely transparent.

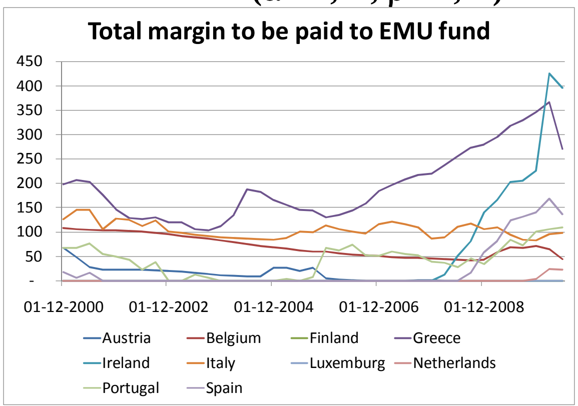
Two illustrative calculations
As stated, setting the parameters α and β is a comparatively arbitrary process. An important question in doing so is of course how sensitive one wants the spread to be in reaction to developments in respectively government debt and the budget deficit. Government debt is important as the best structural indicator of the financial position of the government of a country. The deficit performance,

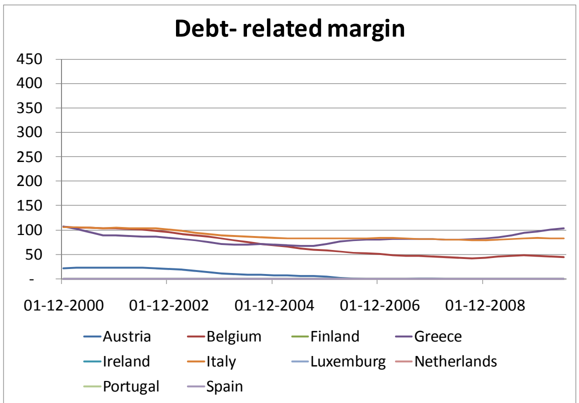
however, obviously best reflects the current state of affairs. In addition, this parameter can be adjusted fairly quickly, also offering rapid rewards for good policy. Driving down public debt that has risen too far is by its very nature a slower process that will take several years. Accordingly, setting the parameters not only involves the relative ratio between the two parameters, but also their level: how far does one want the maximum spread to rise?
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 only 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.

The set of charts below illustrates two scenarios by way of examples. In the first scenario the α is set at 0.025 and the β at 0.02. In this scenario, the margin (calculated in basis points) is relatively sensitive for changes in the public deficit. In the second scenario α is set at 0.015 and the β at 0.05, making the margin less sensitive for the deficit, but more responsive to the development of the public debt ratio.

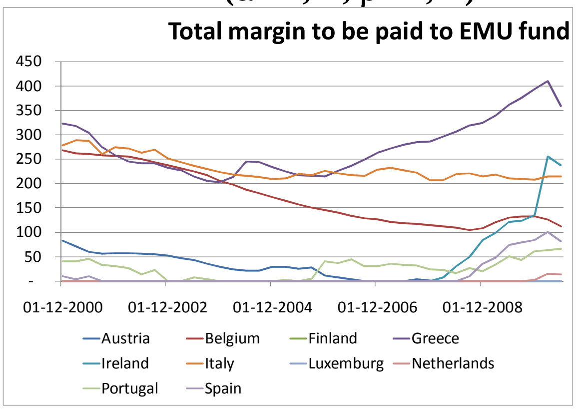
In times when markets do not differentiate, the Fund will be stricter than the market. In the bottom graphs this is illustrated by a positive figure. These countries pay their margin to the Fund, which can be interpreted as an ‘insurance premium’ for bad times. A negative figure illustrates how the fund shelters countries from increasing market pressures. Over time, the sum of margins can be substantial (see table 1), strengthening the EMU fund’s balance sheet.

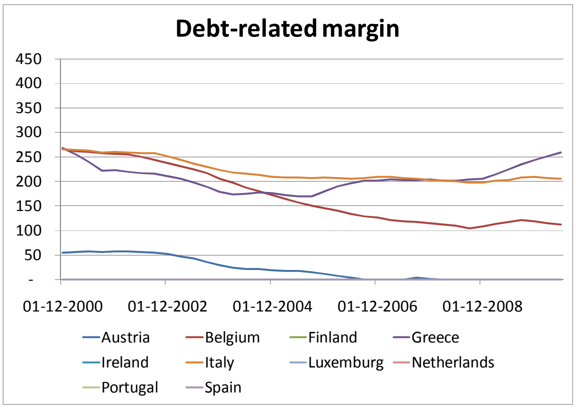
Scenario 1 (α = 0,25; β = 0,02)



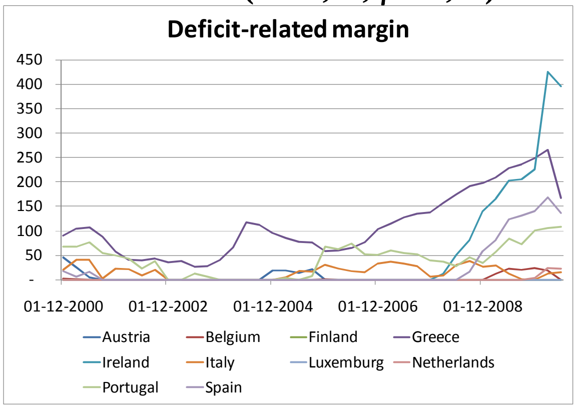


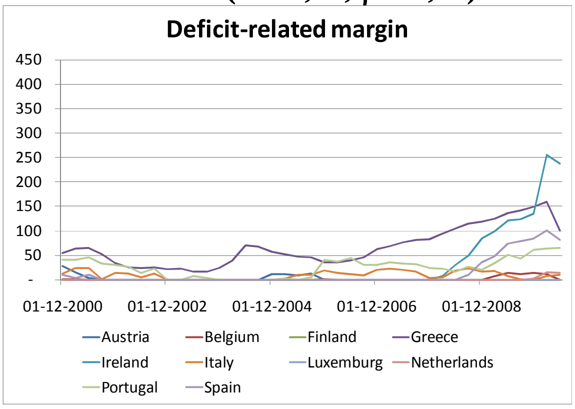
Scenario 2 (α = 0,15; β = 0,05)

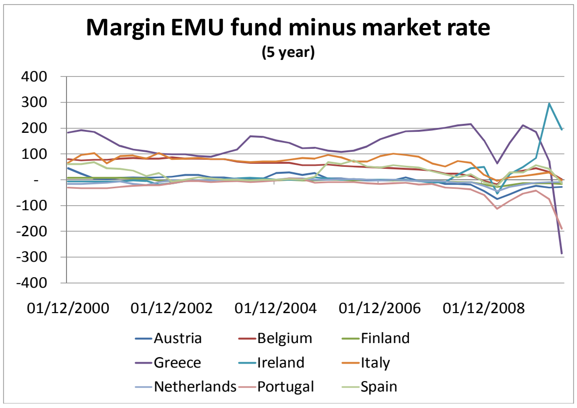


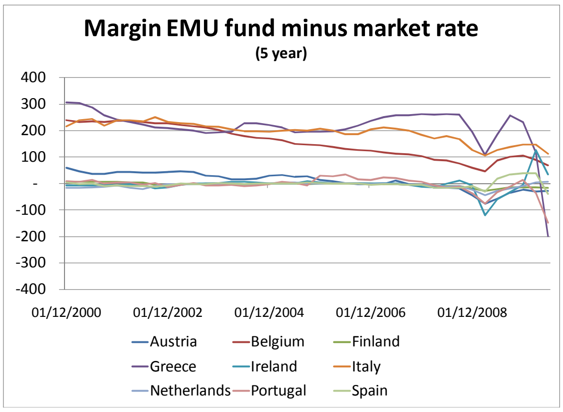


Scenario 1 (α = 0,25; β = 0,02) **Scenario 2 (α = 0,15; β = 0,05)**









Basic information on scenario's

	Scenario 1	**Scenario 2**
Total margins paid to fund (=profit EMU Fund)	€ 1.840 bn.	€ 946 bn.
Contributed by (share in % between brackets):		
- Austria	€ 7 bn. (0.8)	€ 14 bn. (0.7)
- Belgium	€ 80 bn. (8.5)	€ 194 bn. (10.5)
- Greece	€ 163 bn. (17.3)	€ 223 bn. (12.1)
- Ireland	€ 18 bn. (1.9)	€ 11 bn. (0.6)
- Italy	€ 616 bn. (65.1)	€ 1361 bn. (74.0)
- Netherlands	€ 2 bn. (0.2)	€ 1 bn. (0.1)
- Portugal	€ 16 bn. (1.7)	€ 10 bn. (0.5)
- Spain	€ 44 bn. (4.6)	€ 26 bn. (1.4)

Note:
Calculations are based on the calculated margins (see above) and the historical debt and deficit performance. Note that they are very tentative, as they do not take any advantages (such as improved liquidity and thus lower funding costs for the EMU fund) into account. Moreover, as they are based on historical data on public finances, changes in policies under pressure from increased margins (the

disciplinary effect) is not taken into account either. Finally, they assume that the margin is constant over all maturities.
In these examples, Italy is the country that in absolute figures pays the highest margin and contributes the largest share of the EMU fund's 'profits'. This, of course, is the result of the country's size and its huge public debt. It also illustrates that Italy has been the largest 'free rider; in the first decade of EMU. Note, however, that all countries benefit from the improved liquidity in EMU's bond markets and the lower interest rates that may be expected from this. The calculations also nicely illustrate how countries that conduct good fiscal policies are rewarded (note Austria and Belgium) or punished (Greece).

Member states with payment problems: conflict with the NBO clause?
Even if government deficits can in the future only be funded by the EMU fund, a member state can in theory still run into problems servicing its public debt. History is full of countries that fail on their public debt and there is no reason to expect that the future will be different. A monetary union that has the ambition to last forever, should be able to deal with the failure of a member state without too much disruption.[7]
The situation under the EMU-fund would be fundamentally different than in the situation of today. If a country were to default today on servicing its government debt, it has to negotiate with numerous creditors and investors. As the Greek and Irish cases illustrate, even seeking support is messy, politically difficult and adds a lot to uncertainty. Moreover, as in today's situation a financial problem in a single member state immediately threatens the stability of the whole EMU, the stronger countries are more or less forced to organize a bail out.
However, in a situation of central funding of public deficits, any default on the part of a government of an EMU member state leads immediately to a bilateral problem with the EMU fund. The 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. There will be no doubt who will do the negotiations, who will organize the bail out if necessary and who will decide on the conditionality attached.
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 any more to other financial funds. It will no longer be able to turn to the capital markets with a new 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 applying for financial support, to impose very strict and enforceable terms. Moreover, the equity buffer built up by the EMU fund will soon be large enough to deal with such a situation and, maybe more important, ensures the creditworthiness of the fund itself.

In practice things will not easily go that far. Firstly, the margin charged by the EMU fund to member states performing poorly will already rise gradually over time. Governments will therefore already be confronted in an early stage with the consequences of their behaviour and the EMU Fund will see warning lights flashing a long time before things will run out of hand.
A sudden deterioration of the market perception that would cause an acute liquidity shortage for a country within a very short timeframe is in normal circumstances by definition not an issue in the proposed model. Countries will always have access to finance of their new public deficits or refinancing

[7] Note that even when a country fulfils the SGP-criteria for may years it can run into severe financial problems. Ireland is a good example.

needs. 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 rather ineffective sanctions from the SGP must be replaced with, more effective and gradually more painful political sanctions. Think for example of a loss of funds from the EU's structural funds and a gradually increasing loss of political influence in EMU-related decision making (Boonstra, 2005). 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. The chain of sanctions, that will be relatively mild initially, but should have a high profile (such as losing one's voting right in the board of the ECB) but will gradually become more painful for politicians. This must be long enough to span at least one full political cycle.
Concerning the NBO-clause it can be said the that this clause already has been undermined by recent events. The EMU-fund strengthens this clause, as in the long run the countries that default of need a bail-out finance themselves via the margin paid to the EMU fund.

Simple introduction, based on voluntarism
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 in the field of fiscal policy 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.[8]
Participation should be organized on a voluntary basis, no country should be forced to participate against its will. However, as the advantages of the common funding in the form of lower funding costs would be quickly evident, the remaining countries would soon want to join. In the process, the strong countries can require newcomers to accept the system of mark-ups, depending on the quality of their public finances. They are likely to agree swiftly because even for the weaker countries the advantages of the lower average funding costs (owing to the greater liquidity) and the greater stability will comfortably outweigh the mark-up they will be asked to pay. On balance, it may even be expected that in a normal situation ultimately all countries will face lower funding costs.

Practical issues
As with most innovative schemes that look simple at first sight, the devil is in the details. A number of practical issues need to be tackled. In this paragraph, a number of issues will be briefly discussed.

Size versus flexibility
Will the EMU fund be flexible enough to serve the participation countries optimally? On the one hand, it need to issue huge benchmark bonds to make optimal use of its size and create maximum liquidity of its

[8] Note, however, that it is also a possibility that a group of countries with relatively weak public finances decide to pool the funding of their fiscal deficits and start the EMU fund. This would bring them the opportunity of benefitting from the liquidity premium. Moreover, it shields individual countries from sudden changes in market sentiment. This approach would result into minor changes in the design of the EMU-fund. Especially the question how to deal with the entry of financially stronger countries should be solved.

bonds. On the other hand, the countries would prefer to have optimal flexibility in the financing operations and have the freedom of early redemption of outstanding debt.
However, this problem should not be exaggerated. This is the traditional business of consolidated banking groups, like the centrally organized cooperative and savings banking sector where the central organisation deal with these issues on a daily basis. The larger the EMU-Fund, the easier it will be to serve its 'clients' optimally.

Complementary partial plans
The EMU Fund is ambitious in its design. Although it may start with only a relatively small number of countries, it ultimately aims at participation of one hundred percent of the member states. One could also imagine however, that the countries that today are paying the highest interest rates on their bond issues join forces and start to fund their public deficits together via a central agency. This would bring them several advantages as well, such as lower funding costs and integrating their economies more deeply into EMU. Once participating in central funding, no individual country can be targeted by the financial markets as potential 'candidate' for leaving the eurozone.

Beneficial for all participants
It is important to realise that the introduction of central funding of public deficits in the euro area is beneficial for all participating countries. For the countries that are perceived by the markets as relatively weak the benefits are clear. In this construction they are sheltered by the EMU fund from the swings in sentiment on the financial markets. Even in the most turbulent scenarios, markets will never be able to force countries out of the EMU by charging them extreme interest rates or even deny them access to finance. Moreover, even when they are charged a spread, their average funding costs may be expected to be lower and, once they improve their economic policies, the reward in the shape of lower interest rates will be immediately. The price they pay, of course, is that as long as their economic policies are poorer than average, they will have to pay a higher interest rate. They can influence this spread, however, by improving their public finances.

For the stronger countries the most important benefit is the consolidation of the euro for the future and cheaper funding costs, due to the liquidity effect. Also the fact that the EMU-fund may charge a spread to countries that perform relatively poor with their public finances is an advantage. Recent history has taught us that financial markets either are too lax, giving countries with weak public finances a free ride for years, or too violent, adding to the euro's strains. The discipline from the EMU-fund is more gradual and increasing once public finances deteriorate.

Concluding remarks
The basic idea of the proposal presented here is not entirely new (Boonstra (1991), (2005)). The first time this proposal was put forward, in 1991, 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 institutional framework of 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 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 and that the European currency is here to stay. Note that this approach more or less reflects the way France and Germany established the exchange rate mechanism of the European Monetary System in 1979. What started as a relatively modest step by the major countries has culminated in the introduction of the euro twenty years later. When combined with adding stronger and more effectively implemented sanctions to the SGP, de facto combining the German EMF proposal with the idea of the EMU Fund, the eurozone will become more stable and budgetary discipline will have strongly improved. [9]In this approach, a new treaty can be circumvented, as there will be strong market pressures to join the central institution. This automatically includes subscribing the new sanctions. Especially for weak countries, the price for staying out and expose oneself as a fiscal weak country may be too high. The presence of the EMU fund, even if not all countries participate from the start, may be expected to improve market discipline on the policy makers in the countries that chose not to participate. Therefore, the non-adopters may be expected to 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. Even Italy, which so far has benefited the most from the current situation will soon find it attractive to join the scheme. This is because if it remains outside the common funding system it runs the risk of being identified 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.

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[9] The Irish and Spanish cases illustrate that even countries that meet the traditional budget criteria of the SGP can run into serious trouble. A lesson learned could be that the SGP should include other indicators as well, such as indicators on productivity, labour market, banking sector stability and the balance of payments. However, it goes beyond the scope of this paper to elaborate on this issue.

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