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Eurobonds anything but a panacea

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THE latest pressure point in the European crisis is over whether to issue "eurobonds": bonds, collectively guaranteed by the governments of the eurozone, that could fund public expenditure in the region.

The concept of collective borrowing in a federation will hardly be novel to Australians. Already at the constitutional conventions, the founders of our federation saw the scope for joint borrowing as a significant benefit federation would bring. Although it took some time for that aspiration to come to fruition, the 1927 Financial Agreement, devised by that great reformer Stanley Melbourne Bruce, provided a basis for it to occur.

Under the terms of that agreement, the commonwealth agreed to take over the states' outstanding debts, and guarantee new debts, in exchange for continuing contributions by the states to a National Debt Sinking Fund. The states also agreed to co-ordinate all borrowing until 1985 through the Australian Loan Council, on which the commonwealth would have three votes, allowing it to secure a majority with the support of only two states. And as a further check on extravagance, any state borrowing to finance a revenue deficit had to pay interest into the fund at punitive rates.

All this was empowered by a new section 105A of the Constitution, which gave the commonwealth the right to make any law needed to enforce the Financial Agreement, "notwithstanding anything in this Constitution or the Constitution of the several states or any law of the commonwealth or of any state".

Relying on those sweeping powers, the commonwealth's Financial Agreements Enforcement Act allowed it to place a state in receivership and garnish its revenues, as the commonwealth did with NSW during the Lang loans crisis of

1931.

These provisions go vastly beyond the institutional framework that now exists, or is likely to come into being, in the eurozone. Yet they were the indispensable *quid pro quos* for the commonwealth borrowing on the states' behalf and accepting that taxpayers generally would bear the risk of profligacy by individual states. And that was in a context where the conditions for co-operation were far more propitious than they are in Europe today: history, including the recent trauma of World War I, had brought Australians closer together, rather than wrenching them apart; and the commonwealth, unlike the EU, had clear powers of taxation, which acted as collateral to the guarantees on its borrowings. In contrast, the eurozone countries are in a crisis of mutually assured distrust, while their collective instrument, the EU, has virtually no taxing powers of its own.

None of this is to say that joint borrowing in the eurozone is impossible. Indeed, some joint borrowing is provided for under the European Financial Stability Facility and the European Financial Stability Mechanism set up to help finance assistance to Greece and Ireland. But the Germans, the Austrians and the Dutch are understandably reluctant to bear the credit risk for weaker borrowers when they have none of the safeguards over those borrowers' behaviour that our 1927 agreement provided.

As a result, to the extent to which some move occurs towards common bonds, it is likely to be strictly limited. The main proposal at present is for borrowing that would be used to finance only a portion of a country's debts: say the portion corresponding to no more than 30 per cent of its gross domestic product. Moreover, those bonds would have seniority over all other bonds the country issued: so the borrower could not make any payments on the bonds it had issued in its own name before fully meeting the payments due on the bonds that had been issued in common.

But any such scheme will make little or no difference to the interest costs of the highly indebted countries. This is simply because the greater guarantee accorded to the higher seniority debt implies an offsetting increase in the riskiness of the bonds such a country issues in its own name.

As a result, the only gain would come if the bond markets became more liquid, that is, if standardising some of the debt meant there was a higher level of

trading, increasing the ease with which trades could occur and hence reducing their cost. Whether this market size effect is material is controversial. But even were it significant, the gain it would provide to the collectively issued debt would again be offset by a loss of liquidity on the debt each heavily indebted country issued on its own responsibility.

As a result, such a scheme, to the extent to which it is politically feasible (and that requires substantial limits on the extent of the liabilities it would accept), is anything but a panacea. It may have symbolic significance, but its main importance is as a sign of growing desperation. In many respects, it is a case of "failing forward", of stumbling out of disaster, but without getting it quite right.

There is, nonetheless, some prospect of a limited move in the direction of eurobonds. After all, German Chancellor Angela Merkel will be focused on the growing likelihood that French President Nicolas Sarkozy, difficult as he is, will be replaced by the socialist Francois Hollande. While there are constraints on how far she will go to help Sarko, a symbolic step towards eurobonds may be an option. But it would be very symbolic indeed. And it will certainly not bring the euro's crisis to an end, much less address the structural problems that have given rise to that crisis and which, left unresolved, are certain to recur.
