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File EurobondsOptionReasonableEN
- *Serious doubts about the envisaged EIB+ESM strategy*
- *Strategic market creation of Joint Eurobonds (JEBs) necessary*
- *Adequate institutional setting allows avoiding Euro crisis, overcoming the Corona recession in the Eurozone/EU and stimulating global output growth*
- *A wealth tax in Italy and Spain could help to create a larger JEBs volume; ECB buying up to 40%*
- *JEBs could also include as a Basket-JEB the UK: a mix of GBP bonds and Eurozone bonds*

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Joint Eurobonds Needed in the Global Corona Crisis

There is an old and heated debate within the European Union about a new financial instrument, the so-called Eurobond, where Germany, the Netherlands, Austria and Finland have strong caveats against such a mutualization of government debt in such a way. There is considerable fear that Eurobonds would bring a serious bailout risk, not least as the debt-GDP ratios in Italy and Spain were already quite high as were the unemployment rates in both countries in 2019. The strategy envisaged in Brussels in early April 2020 is to mobilize loans from the European Investment Bank (EIB) for small and medium enterprises (SMEs) (in the amount of €200 billion), to provide a back-up loan for national unemployment insurance systems (€ 100 billion) and to rely on the European Stability Mechanism (ESM) which could give loans up to €410 billion to Eurozone member countries; countries could obtain loans - without conditionality – of roughly 2% of gross domestic product. This package, however, will not really work as using the ESM normally comes with a stigmatization effect and the overall package is hardly adequate to avoid a new Euro crisis.

Imposing no conditionality on the loans undermines the credibility of the ESM and thus undermines Eurozone stability at large. The use of an Enhanced Conditions Credit Line at the ESM, coupled with the European Central Bank's newly activated OMT program to buy government bonds, cannot be recommended - Germany's Federal Constitutional Court could stop a broad OMT program.

If loans from the ESM can be obtained without conditionality, the ESM is weakened and thus also prospects for medium-term stability in the Eurozone. The ESM is useful as it is, but a new multilateral fund for fighting the coronavirus crisis is needed. The benchmark of a Eurozone solution to the coronavirus crisis should be based on comparisons with the US and the UK which both rely on massively expansionary fiscal policy combined with expansionary monetary policy plus quantitative easing, namely the respective central banks buying government bonds

on a broad scale in order to keep the real interest rate at a very low level so that the economic upswing can be achieved rather quickly.
A strategic new Eurobonds approach which avoids a new Euro crisis should be based on (7) elements: (1) No special “Corona bond” should be issued, rather a Joint Eurobonds (JEBs) market with maturities of two, ten and thirty years should be developed so that useful yield curve information will become available. Shorter maturities focus on central banks’ interest in currency reserve holding, longer maturities should be attractive for banks and insurance companies. (2) There should be no placement of national bonds for five years in the three JEB maturities mentioned previously. (3) One half of JEBs should be backed by national gold and currency reserves which limits the liability risk of all Eurozone countries; there should be a rule that half of the revenue obtained from JEBs should be used to finance trans-European infrastructure networks – and countries with rather low real income growth rates in the past five years would also have to spend one third on innovation and growth promotion projects. Thus a country like Italy could still use 17% of the new revenue to modernize their national health system. The JEB interest rate will be very low, close to Bund interest rates. Interest payments would be on a pro rata basis where the benchmark is the share of Eurozone GDP in 2019; this creates an incentive for countries such as Italy and Spain to push reforms more towards promoting economic growth. After 2030, interest payments should reflect actual shares in GDP. (4) The ECB could buy up to 40% of JEBs, partly within its new Pandemic Emergency Purchase Programme (PEPP); and the Eurozone would be in a situation similar to that of the UK and the US, namely that the fiscal and monetary policy mix allows to have very low real interest rates for several years – a situation needed to overcome the Corona crisis. A new Eurozone crisis can be avoided so that the economic upswing in the Eurozone could be strong, indeed even faster than in the US or the UK. Thus, JEBs help overcoming the recession, redistribute risks away from Italy, Spain, Greece and Cyprus and reduce the overall risk of the Eurozone while stimulating an OECD economic upswing.
(5) With the new JEBs asset class, the opportunities for the Eurozone to benefit from the privilege of having an international reserve currency would be enhanced. This benefit comes in the form of the difference between the global marginal product of capital and the low interest rate obtained by central banks holding JEBs as reserves; multiplying the yield difference with the stock of global Euro reserves of central banks is part of the Eurozone’s net benefit from the Euro and could reach roughly 0.5 percent of national income: effectively in the form of free goods imports from abroad. JEBs will reduce the risk premiums for Italy and Spain and banks in the Eurozone holding JEBs will need less equity capital and thus have additional room for giving loans. The introduction of JEBs could be based on a newly created multilateral institution in the Eurozone or one could create an additional pillar of an existing Eurozone institution.
(6) The European Parliament should, in the next European election cycle, create a special Eurozone Parliament that could become responsible – after changing EU treaty changes – for implementing JEBs financing in the future.
(7) One may consider in the medium and long run the creation of a Euro fiscal union. There will be enough time to carefully study the various options.
The JEBs would be an innovative and effective EU answer to the challenges of the Corona crisis. With the JEBs approach, the Eurozone can not only overcome the coronavirus-related recession but also create positive economic spillovers for the US and China – with positive repercussion effects on the EU. The overall volume of JEBs should be 3-7% of the Eurozone’s GDP. If one places 1% of GDP in 2020, this amounts to about €110 billion; in 2021 the share in GDP could be slightly above 1% with no offsetting reduction in the Eurozone countries’ planned national bonds placements. Only in 2022 and 2023 would there be offsetting factors of one half and two-thirds, respectively, so that national bond placements are increasingly replaced by JEBs. The European Stability and Growth Pact should fully work again in 2023. The volume of JEBs could move close to 5-7% of Eurozone of GDP only if Italy and Spain impose a special

wealth tax for a few years; 0.3% as a wealth levy should be sufficient as the net wealth of the private sector in Spain was roughly ten times gross disposable income in that country in 2019, in Italy, the ratio of net wealth to gross disposable income was about 9, in France 8, and in Germany close to 7. With the bigger JEBs package, the output decline in Italy and Spain could be only about half as deep as a scenario without a Joint Eurobond package deal.
JEBs would contribute to stronger competition in global bonds markets and stimulate innovation and growth. It is not ruled out that a hybrid Basket JEB with the cooperation of the UK – including GBP bonds and Eurozone bonds - would be created. Here lies an opportunity for the UK and the EU to demonstrate a common interest in jointly fighting the Corona crisis. Such a strategic approach could be very useful for Europe and the world economy as the stabilization of Europe also contributes to stabilizing Northern American and Asia.

Related research "The Global Trump", London: Palgrave, 2019.
Talk Prof. Welfens at UC Berkeley in February 2020 (Link)