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Economists' Group Backs Euro Bonds

By PAUL HANNON

LONDON—A group of leading economists on Monday backed the issuance of euro bonds, not as a way of resolving the currency area's fiscal crisis, but as way of making the global monetary system more stable.

In a report published by the Centre for Economic Policy Research, the economists also recommended that swap agreements between leading central banks be made permanent, that the International Monetary Fund be allowed to borrow in the bond markets to boost its lending capacity, that foreign-exchange reserves be pooled, and said capital controls should be used to curb "excessive and volatile" investment flows to developing economies.

In the report, Emmanuel Fahri of Harvard University, Pierre-Olivier Gourinchas of the University of California, Berkeley, and Hélène Rey of the London Business School said that since the collapse of the Bretton Woods Agreement in 1971, international monetary relationships had been governed by a "nonsystem" that may have been "an aggravating factor—or even a trigger—of the financial imbalances at the root of the recent financial crisis."

One of the key problems, they said, is that growing demand for reserve assets from developing countries isn't being matched by supply.

At present, U.S. Treasury bonds are the dominant reserve asset, but that has some negative consequences, including U.S. interest rates that are too low and lead to bubbles and too much borrowing. That, in turn, contributes to global imbalances, chiefly large U.S. trade deficits matched by surpluses elsewhere—especially in China.

The three economists said that to address this problem, steps should be taken to "promote the development of alternatives to U.S. Treasuries as a dominant reserve asset in order to accelerate the inevitable transition to a multipolar system."

"Towards this end, the issuance of mutually guaranteed European bonds seems particularly desirable," they said.

Although the euro zone's economy is comparable in size to that of the U.S., its bonds market is fragmented, with each member nation issuing its own securities.

Polling issuance could create a bond market similar in size to that for U.S. Treasuries, thereby boosting liquidity. Because they are easily bought and sold, Treasuries have the advantage of being almost like money, which is one of their key attractions as a reserve asset.
Over the longer term, the economists also said the development of a yuan-denominated bond market was also necessary to ensure a stable monetary system.

As the euro zone’s fiscal crisis has worsened, support for the issuance of euro-zone bonds has grown, although the currency area's leading governments—those of Germany and France—continue to resist the idea.

They argue the issuance of mutually guaranteed bonds would encourage profligate behavior by governments, and would require much closer coordination of budget and broader economic policies that currently exists in the euro zone or seems politically possible in the future.

Speaking Friday, German Chancellor Angela Merkel once again ruled out euro-zone bonds, saying that "under no circumstances" would they constitute a viable future fiscal policy for Europe.

Nevertheless, José Manuel Barroso, president of the European Commission, which proposes European Union legislation, said Wednesday it would soon put forward options for such bonds. That is a long way from actually issuing them, but it will place the idea officially before governments for the first time.

European Commission Vice President Viviane Reding on Friday urged France and Germany to issue euro-zone bonds immediately, thereby creating a large, triple A-rated bond market that could compete in size and liquidity with the U.S. market.

The CEPR is a network of 700 leading economists based in universities and research institutes in Europe and the U.S.

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