FINANCIAL TIMES

November 23, 2011 7:28 pm

Eurobonds: moral hazard ahead

If eurozone nations cannot borrow separately, perhaps they can borrow together. That is the logic behind the common debt issuance idea – eurozone bonds – being mooted by the European Commission. Those in favour could cite Wednesday's other, more scary development – investors turning their backs on a German bond issue – to bolster the case that more liquid collective debt would help to trump countries' individual difficulties. It is the very crisis the region is trying to fight, however, that makes the joint bond concept look like whimsy.

Eurozone government debt will be about 88 per cent of gross domestic product in 2011. That is lower than in the US or Japan. Proponents of eurozone bonds argue that pooling risk would spread the benefits of this to lower-rated members through reduced financing costs.

Peripheral countries would benefit disproportionately, thereby helping to ease overall debt burdens. The weighted average of the eurozone's borrowing costs is 4.7 per cent. Greece could cut its interest bill by 15 per cent of GDP in this way, according to Capital Economics. Germany's interest bill would rise proportionately, of course – by some 2.5 per cent of GDP. What's not to like?

Moral hazard, for starters. By offering the likes of Greece or Italy such rewards, eurozone bonds could remove these countries' incentive to regain lost competitiveness. Nor would these bonds reduce the stock of existing debt. Unless there was a degree of fiscal union and budgetary enforcement in the eurozone that trampled on national sovereignty, investors would rightly be sceptical about buying such instruments. If the yield on eurozone bonds was to become significantly higher than that on debt of the bloc's triple A states, the project would crumble.

And then there is the clinching argument – that Germany will not accept them. An ersatz form of eurozone bond issued by the European Financial Stability Facility already exists. Anything more ambitious is a non-starter until the crisis has abated.

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