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On the future of the euro

As noted above we are starting a short, irregular series of articles on the future of the eurozone - or some of its institutions - prompted by some interesting papers and proposals that are currently floating around. We are also happy to consider unpublished ideas from readers, but insist that the discussions meet two criteria. The first is that they are not driven by the politics of one or two countries, but a genuine desire to solve the eurozone's actual problems, however you may define them. This is the reason why we have become so dismissive of the various Franco-German discussions, which are getting nowhere precisely because they are driven by the two countries' red lines. The other criterion is that solutions have to be eurozone-wide, i.e. make the euro sustainable for all of its members.

The deep reason behind the two criteria above is that almost every decent proposal will require treaty change - at least at some point. Since treaty change requires unanimity, it is essential that we are not wasting political capital on some half-hearted measures that will fail to do the heavy lifting, like a synthetic eurobond CDO.

In that spirit, we note an important proposal by four Italian economists, Giovanni Dosi, Marcello Minenna, Andrea Roventini and Roberto Violi who have spent some time devising a risk-sharing mechanism based on a redefinition of the role of the ESM. Their idea is to turn the ESM into a debt agency with the specific role to guarantee the public debt of member states, but to do so at the market price of providing these guarantees. As in private-sector financial transactions, such a structure may have to involve additional layers of equity capital to ensure that the ESM can continue to refinance itself as a AAA-rated borrower. The authors see this risk-sharing mechanism as a transitional arrangement only - until a full transition is achieved from national debt to a single eurozone safe asset. This is clearly one of the most ambitious safe-asset proposals we have seen, one that goes beyond the partial mutualisation inherent in some of the other proposals, like the blue-bond-red-bond idea and other variants.

The road map towards a eurozone bond would have to involve the ESM going beyond guaranteeing existing government bonds, by issuing its own bonds with varying maturities. Together, the ESM-issued liability and the guaranteed government bonds would constitute a safe asset. The authors argue that such a structure would correct one of the main anomalies of the eurozone. In the past, the role of the safe asset was taken up predominately by German governement bonds. But their scarcity, especially in relation to the size of the eurozone economy, requires a new instrument.

There are several other aspects of the proposal we cannot do justice to in this short discussion, but we note the authors' acknowledgement that it requires at the very least a shift in the no-bailout rules. We think that it requires a lot more treaty change than that. In particular it would have to end the important principle of rules-based fiscal sovereignty of member states.