In recent weeks, euro bonds have gained traction in policy circles as the solution to the sovereign-debt crisis.

The proposed debt could be structured in different ways, but in all cases it would imply joint and severally issued obligations by the members of the euro zone and would fundamentally change the fiscal operations of the union.

Given their permanent nature and lasting impact, euro bonds shouldn’t be considered merely as a way to contain the current crisis, but also as a tool to prevent future outbreaks. They would fare poorly in both tasks.

Euro bonds aren’t necessary to contain the crisis: Better, more targeted solutions are available. And they aren’t suitable for achieving institutional reforms, which should be separate from short-term measures, and designed to strengthen the long-term viability and resilience of the euro zone’s economic and political structures.

In this regard, these securities are a bad idea not because they would provide transfers to weaker member states, as is often pointed out, but because the transfers would be neither transparent nor controllable. Indeed, euro bonds would cement Europe’s structural problems.

Any lasting solution must clearly distinguish between illiquidity, insolvency and structural deficiencies, and should address each in a transparent manner, considering the political processes involved. By contrast, the euro bond proposals fail to differentiate between these issues and, as a result, hurt transparency and incentives.

Targeted Aid

This doesn’t mean that member states experiencing difficulties shouldn’t receive help: Conditional loans and transfers in support of structural reforms can help countries regain a sustainable competitive position and reduce current-account deficits and public-sector debt.
In any monetary union, even a well-functioning one, imbalances in regional current accounts will develop from time to time. If they accumulate into ever-increasing net debt positions, they have to be corrected. But within a monetary union, current-account deficits cannot be addressed by devaluing the currency.

Instead, policy makers have only three measures: an alignment of real wages; increased mobility of labor between regions; or transfers between countries to support those that are lagging behind. It should be noted, though, that adjustments also include cuts, often painful ones, in public expenditures as well as tax increases.

Benefits, Obligations

While transfers are disliked by many, at least in northern Europe (or northern Italy), it is understood that a viable monetary and economic union doesn’t only have benefits, but obligations, too. This reminder applies particularly to Germany and other highly competitive regions that have benefited from the European Union’s common market and an enduring period of monetary stability.

But transfers to weaker members aren’t simply justified on those grounds; they can also make economic sense. This is particularly true when the payments are directed toward investments with positive externalities, such as infrastructure and education, that help increase productivity and allow deficit countries to escape their downward spiral.

Most importantly, conditional transfers have a decisive advantage: They are transparent and limited in size and duration. This allows for accountability as well as benchmarking. For these reasons, transfers can be an element of a modern “development union.”

Uniform Spreads

Euro bonds, however, provide transfers to weaker countries through a reduction in their credit spreads. They help these countries economically, but the transfers are hidden, not targeted, and uncontrolled in magnitude or duration. These are fatal flaws because subsidies embedded in interest rates cannot be controlled in a way that makes them conditional on better behavior. In view of the deep-seated structural problems that have given rise to imbalances with the euro zone, joint euro bonds would in fact prolong an inherently unsustainable situation.

Moreover, euro bond proponents see them as the means to reduce the current market uncertainty about the credit of Greece and other sovereign debtors. This line of reasoning mistakenly maintains that prevailing euro zone spreads mainly reflect liquidity problems that are endemic to a monetary
union in which states can no longer count on their national central bank as a liquidity backstop. Thus, rollover problems easily lead to a downward spiral, to which euro bonds are seen as an answer.

Offloading Costs

Yet liquidity is hardly the whole story. If credit spreads also reflect insolvency and structural problems, as is the case in Europe now, euro bonds aren’t an appropriate answer because they offload costs to third parties and provide few incentives to fix underlying problems. In addition, short-term liquidity problems could be handled by the European Financial Stability Fund and its successor, and in extreme cases, by the European Central Bank.

Further, by averaging default probabilities, euro bonds distort the interest rates at which countries can borrow and thereby eliminate important signals to the markets. Interest-rate spreads should reflect a country’s creditworthiness, and should tell the public as well as politicians whether a country’s fiscal policy is judged as sustainable. The spreads also provide appropriate incentives for states to keep their debt in check.

Implicit Guarantees

Euro bonds cannot perform this role because of their one-size-fits-all pricing. This is particularly important because fundamentally unjustified interest-rate convergence is a root cause of the current euro-zone problems. Yet the market for sovereign debt can perform this important role only if liability is clearly established and there is no implicit bailout guarantee.

That is why it is imperative to also solve the problem of those guarantees for systemically important financial institutions. That will require appropriate bankruptcy procedures for banks as well as for sovereigns. There remains a substantial need for improvement and regulatory action in this area.

While targeted, conditional transfers are a better way to resolve the current structural problems than euro bonds, they are no panacea. The euro zone must also deal resolutely with the current link between the banking sector and the risk of sovereign borrowers.

Doing so will require a recapitalization of European banks so that the debt of insolvent countries can be restructured. Creating a working institutional environment in all euro regions may require structural aid from the stronger countries, but such help should be transparent and come with effective strings attached.
(Hans-Helmut Kotz, a former member of the executive board of the Bundesbank, is a senior fellow at Goethe University’s Center for Financial Studies in Frankfurt and a visiting scholar at Harvard University. Jan Pieter Krahnen is a professor of finance at Goethe University. Christian Leuz is a professor of international economics, finance and accounting at the University of Chicago Booth School of Business and a contributor to Business Class. The opinions expressed are their own.)

To contact the writers of this article: Hans-Helmut Kotz at kotz@ifk-cfs.de; Jan Pieter Krahnen at krahnen@wiwi.uni-frankfurt.de; Christian Leuz at christian.leuz@chicagobooth.edu.

To contact the editor responsible for this article: Max Berley at mberley@bloomberg.net