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Eurobonds: Just because you want to ignore economics does not mean that economics will ignore you [1]

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The game now is that everyone sits round the table, staring at Germany until it blinks. Eurozone leaders figure the only way to save the euro is for all 17 member nations to get together and issue 'eurobonds'. There are some big hitters among those who think this is a really good idea ? people like the new President of France, Francois Holland, the Italian Prime Minister Mario Monti, and the European Commission President Jose Manuel Barroso.

Right now, when eurozone countries want to borrow money, they issue their own bonds, selling them to investors for cash and the promise of a return ? a rate of interest paid each year over a specified period, say ten years. Sadly, it has become nigh impossible for the government of Greece to finance its spending this way, because investors figure that its promises to repay are so shaky they demand double-digit rates of interest ? which is cripplingly difficult for Greek taxpayers to fund, making it even harder for the country to stay afloat. And there are precious few people prepared to take the risk that Greece will actually be able to repay them in anything like ten years from now.

So the plan is that the eurozone as a whole should step in and issue its own eurobonds. The promise to pay lenders interest and indeed to repay their principal at the end of the term would be collectively guaranteed by all 17 nations. So eurozone countries, including those in trouble such as Greece, Ireland and Portugal (and those who are likely to be in trouble soon, like Spain and Italy) could borrow at realistic rates of interest, without crippling themselves.

That is good news for the troubled countries, because it means that all countries in the eurozone would actually be able to borrow at the same interest rate.The snag is that any such country cannot actually pay its share of the interest and principal payments when they become due, the other countries would have to help them out. And the stronger countries are not exactly thrilled at this prospect.

Nor should they be. In the first place, the eurobond idea distorts the price mechanism. If you are lending to someone, the interest you get in return should reward not only your forbearance but the risk you run of not being repaid when you want your money back. Lumping risky and non-risky (well, less risky) countries together means that prices no longer reflect that risk. The risk is pooled. Specifically, the stronger countries are subsidising the risks that are being run by the weaker ones. And when you subsidise something, you generally get more of it. But who wants weak countries to live beyond their means and take a bigger risk of running out of money than they already have done? We had enough of that from the banks, thank you very much.

But the system builds in moral hazard for the over-spent, over-borrowed countries to do exactly that. Live

beyond your means, and your richer cousins will underwrite your profligacy and pay people to keep lending to you. Act prudently, and you get hit for a bill from the imprudent nations.

When it comes down to it, of course, Germany has the broadest shoulders. France might think itself in the same league, but actually investors reckon that is a pretty bad bet too ? all the more so now that it has a socialist president who figures that balancing the books is for the birds. The German public certainly can't see why they should pay for other people's profligacy. Germany and the other stronger countries would in fact find it more expensive to borrow themselves, because they would be sharing the cost of the weaker countries' borrowing too.

Will it happen, though? Yes, quite probably. The alternative is to let Greece slide out of the euro, followed probably by a number of others that just can't make the grade. That would be messy, and it would cost European banks a lot of money ? urged on by regulators, the banks hold a lot of government bonds, which were always reckoned to be safe investments. Though now, patently, they are not. That purely financial concern is what is in George Osborne's mind. But the real concern of pretty much everyone else is a political concern: that the exit of any country marks a retreat from the EU idea of deeper and closer integration, the fear that the European Project would find itself on a falling tide. And that they find deeply shocking.

The euro was always a political rather than an economic venture. But, as my economist friend Richard Jeffrey of Cazenove Capital puts it: "Just because you want to ignore economics does not mean that economics will ignore you." It's painfully clear what the end will be. The only question is how long it will be postponed, and at what cost.

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