Plan to bail-in EU governments' bonds will be end of sovereignty

By Craig Isherwood

A newly announced German plan to formally "bail in" sovereign government debt is sending shock waves throughout the world, especially the Eurozone (the 19 countries of the euro single-currency bloc). This latest bail-in proposal attacks the last vestige of "safe" investment—government bonds—and represents a further attack on the sovereignty of nations.

The German Council of Economic Experts, which consists of five members nominated by the German government and appointed by Germany's President, in its November 2015 report *Focus on Future Viability* proposed a plan that calls for a "sovereign insolvency mechanism". Feeding off Greece's sovereign default experience, the plan outlines how holders of government bonds within the Eurozone would be the first to suffer losses in any future sovereign debt crisis by being bailed in, before any rescue is attempted from Eurozone bail-out fund the European Stability Mechanism (ESM). In other words, no more sovereign bail-outs.

This plan has the backing of Germany's central bank the Bundesbank and, not surprisingly, Wolfgang Schäuble, Germany's finance minister. Schäuble has always wanted to re-establish the very contentious "no bail-out" clause of the original Maastricht Treaty and enact enforceable sanctions to punish sovereign nations (and their citizens) whose governments "mismanage" their fiscal affairs—i.e. spend money on social services. To wit—the suffering and austerity in Greece. Schäuble has always preferred the "Grexit" option for Greece—and this plan may just provide it.

Speaking to British establishment mouthpiece Ambrose Evans Pritchard at the London *Telegraph* on 15 February, Professor Peter Bofinger, one of the five members of the German Council of Economic Experts, admitted that the plan from his own council was "misconceived". He said "It is the fastest way to break up the Eurozone … A speculative attack could come very fast. If I were a politician in Italy and I was confronted by this sort of insolvency risk I would want to go back to my own currency as fast as possible, because that is the only way to avoid going bankrupt."

Government bonds are issued in order to raise funds for the governments to function. They are the safest possible investment, generally regarded as having zero risk, as they are backed by the assets and people of a nation. Australia has raised bonds (i.e. issued sovereign debt) totalling $371.3 billion to date, and at December 2014 sovereign debt was 33.9 per cent of GDP. The low risk associated with bonds is usually also associated with low yields or interest payments to the bond holders. Long term Australian Treasury bonds offer yields of only 2.75-3.75 per cent—whereas other bonds pay rates of up to 8 per cent (see "Australia's bail-in by stealth", *AAS* Vol. 18 No. 6, 10 Feb. 2016). However, there are many people who prefer not to gamble with their savings or livelihoods, and look to these types of investments for future security.

The governments of the Eurozone countries, which are the subject to this latest "insolvency mechanism", can issue bonds denominated in euros, which are regarded as the sovereign debt of that country. However, the EU's "stability and growth pact" limits the amount member countries can borrow this way to below 60 per cent of the country's GDP. Moreover, the issued debt cannot be used to fund deficits directly.

Professor Peter Bofinger

This 60 per cent limit has already been smashed. Greece's sovereign debt now exceeds 179 per cent of GDP, despite all the bail-outs and haircuts, due to the EU-mandated austerity that has shrunk Greece's economy; Spain's debt is expected to rise to 100.7 per cent of GDP; Ireland's debt was 98.4 per cent GDP in December 2015; Portugal was 130.2 per cent in December 2015; Iceland 86.4 per cent in December 2014; and Italy's debt is now 132.8 per cent of GDP.

Government bond bail-ins have already occurred in the Eurozone. In March 2012, in an attempt to manage Greece's sovereign debt default, the so-called "Troika"—the European Commission, the European Central Bank and the International Monetary Fund—forced the majority of private holders of Greek government bonds to trade in their bonds for new bonds with a longer maturity, less than half the face value, and a lower interest rate. The largest sovereign-debt restructuring (bail-in) in history, this allowed Greece to wipe some €100 billion ($130 billion) from its total sovereign debt of around €350 billion. Greece had been the first country to declare sovereign default, in 2010, followed by Ireland and Portugal.

However, until now the application of the various EU responses to each of these country's problems, including government bond bail-ins, was decided on a case by case basis; Schäuble's "sovereign insolvency mechanism" will make government debt bail-ins automatic, for the first time. Goodbye sovereignty.

Prof. Bofinger told *The Telegraph* he opposed the way this plan destroys sovereignty. "We can't allow a regime where markets are masters of governments", he said, confirming that it will either force debt-ridden countries out of the Eurozone, or, if they stay, destroy all confidence in that government's bonds and make them entirely reliant on the EU for everything, thus destroying their last semblance of national sovereignty.

Like bail-in generally, this plan will not work as a financial solution, as it will so destroy confidence in the foundations of the financial system that it will hasten economic collapse. In a paper in February, Prof. Bofinger wrote that the Council understands that this insolvency mechanism would become a self-fulfilling prophecy, as it acknowledges, in its own publication, that "The mere announcement of an insolvency regime could cause considerable turbulence on the financial markets, which makes its introduction impractical at this time."