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# Reducing euro area government debt

Why the ECB should restore zero bond spreads

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It is time for the European Central Bank to take action to end a persistent source of disequilibrium in the euro area, by restoring a zero interest rate spread between the bond markets of the different member countries. The way to achieve this is through a redesigned anti-spread shield resembling the Outright Monetary Transactions announced in September 2012 but without the strong policy conditions that have limited its effectiveness. By taking this initiative, the ECB would correct dysfunctionality at the heart of the euro, rebalancing the costs of debt servicing and refinancing for every euro area country.

A revitalised OMT plan should be coupled with the ECB's continuing purchases of government bonds under its March 2015 quantitative easing programme. At the same time the ECB would need to tailor its policies to the more ambitious goal of achieving a 2% inflation rate, not just as a euro area average, but as an actual level in all countries, regardless of the size of their government debts.

This new ECB approach should be linked to an across-the-board relaxation of austerity across Europe, in particular a more realistic set of budgetary targets for individual countries. The combined effect would produce a much more healthy set of debt and interest rate structures throughout the euro bloc.

At present, euro member states with higher government debt to GDP are doubly penalised. They suffer higher interest rates on government borrowing compared with Germany. And they run a lower inflation rate (with outright deflation in some countries such as Greece). These factors have a self-perpetuating effect in enhancing the real level of debt in periphery countries, inducing a never-ending perception of crisis.

The overall impact of a remodelled OMT, relaxation of austerity and a 2% inflation target for each country would break through this vicious circle. Based on what happened after the ECB's 2012 policy changes, probably the mere announcement of a new ECB strategy would be sufficient to drive interest rates on government bond markets towards a zero spread structure.

Just as in the case of the original OMT, provided the ECB's commitment was sufficiently strong and energetic, the ECB could achieve its new aim without substantially changing the overall format of the current €60bn a month QE programme. The ECB would have to revise some of the purchasing limits of this programme in line with its more ambitious, country-specific inflation targets.

We are aware that this plan would be controversial. In particular, German policy-makers and commentators would oppose tampering with the QE limits and have persistently declared that a return to the zero spreads ruling up until 2007 is both unlikely and undesirable, on the grounds that countries with higher debt 'deserve' a higher yield spread compared with Germany.

However, enacting this plan is overdue. Years of significant spreads on sovereign bonds have distorted the competitiveness of national economies by creating a long period of generally higher financing costs, with strong asymmetries among member states. This phenomenon has been crucial in greatly driving up borrowing costs for much of Greek industry. This has been one of the reasons, for example, why German steel companies have virtually taken over the European market share of the Greek steel industry. These asymmetries have inflated the cost of funding for small and medium-sized businesses in most periphery countries.

The negative effects have undermined the European financial system. The German government has been able to refinance its debt at negligible, if not negative, gaining a reduction of interest expenses of almost €20bn over the last five years. By contrast Greece in the same period has been overwhelmed by debt with a nominal value of €320bn, which the financial market values at only €140bn, based on current prices for Greek government bonds.

Greece's negative inflation rates of between 2 and 3% in recent years have substantially increased the real value of Greece's debt. Conversely, Germany has been rewarded by not suffering deflation. Ensuring that the 2% inflation target applied individually to all countries, not simply as an average, would over time dramatically improve member states' level of government debt to GDP.

Based on the present starting level of €2.2tn government debt in Germany, €2.1tn in Italy and €2tn in France, and assuming a zero spread, a 2% inflation rate for all, and more favourable GDP growth, the euro area government debt picture would be transformed over the next 10 years. Germany's government debt to GDP would fall from 75% to 40%, well under the Maastricht criterion of 60%. France's debt burden would fall from 95% to 85%, Italy's from 132% to near 100%, Spain's from 97% to 90% and Greece's from 180% to 140%.

Easing austerity and restoring growth and inflation in every euro area country would counter the politically pernicious impression that the single currency has promoted divisiveness rather than unity. The euro area would look much healthier. The ECB – provided it is backed comprehensively by all member countries – has the chance of making a real difference. Using a favourable period after the ebbing of recent turbulence over Greece, the ECB should once again seize the opportunity of showing leadership.

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