Charlemagne

The name's Bond. Eurobond

The European Union finds an unexpected new hero in the financial markets

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IN EUROPE over the past year, Bond has been the villain rather than the hero. Licensed to kill national economies, he brought down first Greece and then Ireland. Portugal and others are now cowering in fear. This Bond, it seems, is the agent of sinister Anglo-Saxon market forces seeking to destroy Europe's single currency. Such is the story most commonly told since the start of the euro zone's sovereign-debt crisis.

Of late, though, the villain has been partially rehabilitated. For the new Bond is now said to be a European federalist in disguise. As José Manuel Barroso, president of the European Commission, has claimed, "the markets are sending every day a very clear message that Europe has to work in a more co-ordinated manner when it comes to economic and financial issues." Jean-Claude Juncker, president of the euro group of finance ministers, insists that the euro zone has "the confidence of the market". The proof, he says, was the strong demand for the commission's first issue of bonds this month to raise money for Ireland's bail-out, at an interest rate of only 2.6%.

Does the new Bond really want "more Europe"? Talk to market participants and the surprising answer is often yes. This is not out of love for the European dream, but rather out of fear of catastrophic losses. More decisive action is needed by the solvent north European countries, they are saying, to stop the crisis spreading right across the southern belt.

After the launch of the euro in 1999 the bond markets were quick to shake off their doubts about the durability of monetary union without a common fiscal or economic policy. The risk of devaluation was gone and the chance of default seemed tiny, to judge from the markets' judgment that bonds issued by thrifty states were barely worth any more than those of profligate ones. It was only late in the global crisis, when Greece admitted to lying about its numbers, that the markets woke up from their torpor into a sudden panic over sovereign risk.

Governments responded first by signing over vast emergency loans to Greece and then by creating an even vaster temporary loan facility (partly using IMF money). They drew on this for Ireland's recent rescue. The temporary will now become permanent, requiring a change to the EU treaties, with a new system under which the euro zone can in future restructure the debts of insolvent countries that share the currency.

The commission is seeking to bolster what it calls "economic governance": tougher monitoring of the budgets and economic policies of euro members, with the authority to issue warnings and even impose penalties against those (including surplus countries) that do not comply with Brussels's prescriptions. The EU is now embarked on its "European semester": the early submission of national budget plans and reform programmes to Brussels for scrutiny and peer review before they go before national parliaments. There is vague talk of deeper co-ordination. The Germans have spoken of setting a common retirement age across the EU; the French want more tax harmonisation.

All this goes far beyond what EU officials thought possible a year ago. Among other things, it will make Eurosceptic countries, notably Britain, far less likely ever to join the single currency. But will European governance assuage the bond markets? It has not so far. The markets' view, as far as anyone can tell, is that the EU bail-out funds must be expanded to remove any doubt about their capacity to save Portugal and Spain. Joint Eurobonds for part of the sovereign debt, called for by Mr Juncker and the Italian finance minister, Giulio Tremonti, might also reassure the markets. Above all, the markets want to see more common purpose from bickering European leaders.

Their political dispute centres on two questions. First, are the most solvent states, above all Germany, prepared to stand behind and if need be to subsidise the less solvent ones? Second, are the most indebted countries ready to endure economic pain—wage cuts, the end of cherished benefits and the imposition of labour-market reforms—to balance the books and encourage growth? The more convincingly the answer "Yes" applies to both questions, the faster calm will be restored. But so far the response has been slow, hesitant and contradictory.

Successful recent sales of bonds by Portugal, Spain and Italy have provided some relief. Germany says the EU should now seek an all-embracing deal, including on the size and scope of the bail-out fund, in time for the next summit in March. The commission retorts that the euro zone does not have the luxury of time: the markets have been "doped" by the opaque bond-buying by the European Central Bank (ECB), and probably by China and Japan, and need a clearer signal of action.

North is north and south is south

Do not expect the panic to be over soon. Northerners do not want to pay for the mess made by southerners. The olive belt cannot conceive of the harsh and unprotesting adjustment that Baltic countries have endured (with Estonia then leading the way into the euro). Many countries need years of austerity and reforms to regain lost competitiveness. Greater co-ordination and exhortation may help. But Mr Barroso and Mr Juncker and their promise of more European governance ultimately lack the persuasive power of the bond markets. Indeed, their plans will work only if markets remain alert, ready to jump on any hints of backsliding.

Calls for much greater "solidarity" from rich countries should therefore be treated warily, as should any suggestions that Brussels ought to seek to disarm markets by restricting derivatives trading or short-selling. The new Bond could turn out to be Europe's best friend in the end—but only if he is able to keep governments in fear for their lives.