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EUROBONDS: CONCEPTS AND IMPLICATIONS

Briefing Note

Abstract

This note starts by displaying the pros and cons of Eurobonds and then continues to describe the different Eurobonds concepts developed so far by different authors. The note finds more benefits than downsides in well designed Eurobonds and argues that, in the medium term, Eurobonds are going to be the key element for the success of the euro area and the euro. But, in the short term, they may be difficult to implement. The author claims that Eurobonds already exist in the form of EFSF bond issues which only have a proportional guarantee but not the joint guarantee of a proper Eurobond.

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EXECUTIVE SUMMARY

Eurobonds are today a subject of heated debate among euro area policy makers when trying to find a proper exit to the present Euro sovereign debt crisis, even if it is quite clear that they have more pros than cons. There is wide agreement on the fact that, in the medium term, Eurobonds are going to be the key element for the success of the euro area and of the euro. But, in the short term, they may be difficult to implement until those Member States with the highest credit rating feel comfortable with a new and stricter fiscal framework for the euro area which avoids moral hazard by any euro area Member State or, even better, a proper design of Eurobonds which also would avoid moral hazard.

The present euro sovereign debt crisis is mainly the result of a poor and badly designed fiscal governance of the euro area which was criticised, from the very beginning, by a large majority of academics who saw the potential dangers of having a monetary union without even a light fiscal union or a large fund to attend to asymmetric shocks, being real or financial. These dangers have lately become apparent for financial markets, which have lost trust in the future of the euro area and are even showing doubts about the survival of the euro as it is designed today. This lack of trust may become endemic unless the euro area leaders come with solutions that can regain their confidence, which is not being the case today and, unfortunately, the inflexible attitude of a minority of Member States could end up producing even greater mistrust by markets unless a reasonable solution is agreed at the end of March. Going forward, Eurobonds are going to be essential to regain confidence from the markets and from the large majority of euro area citizens.

Eurobonds already exist, given that the EFSF bond issues are practically the same except that their guarantee is proportional to the Member States' participation in the capital of the ECB and is not a joint guarantee, a feature proper Eurobonds need to have for being successful. The quickest way to avoid moral hazard is a full fiscal union where high debt Member States lose fiscal sovereignty, but, at the same time, the best way to reach in the future a fiscal union is by making more debt partially guaranteed by an increasing number of euro area Member States. This way would produce the right incentives to get present levels of debt down and a common fiscal policy and not the other way round.

1. PROS AND CONS OF EUROBONDS

1.1 Benefits

First, Eurobonds would be a decisive step towards a necessary medium term fiscal union and a first step towards a longer term political union.

Second, they could reduce and even stop the present series of self-fulfilling attacks to fiscally vulnerable Member States and contagion to other Member States with less fiscal vulnerability.

Third, they could, eventually, bring back financial stability to the euro area, given that joint guaranties or liabilities could convince markets that its Member States are really serious about achieving a proper fiscal union and a stable euro.

Fourth, they could reduce the cost of debt of most euro area Member States and eventually of all of them through the much larger size, depth, liquidity and diversification of such a market which could reach the same status than the US Treasury bond market.

Fifth, lower cost of debt and very large attraction to large government and private investors that need to diversify their investments beyond US dollars could help the euro area Member States to achieve earlier sustainable debt levels, faster recovery of economic activity and higher economic growth potential by returning faster to more normal levels of public investment.

1.2 Costs

First, a Eurobond, jointly guaranteed by euro area Member States, contains an implicit insurance for all participating Member States and some of them may have an incentive to issue too much debt to profit from such an implicit guarantee (when they could only issue too little debt before the existence of the Eurobond) creating a 'moral hazard' issue and its consequent rejection by the most fiscally responsible Member States.

Second, some AAA rated Member States, such as Germany, may have temporarily to pay a slightly higher interest rate on its debt, given the inclusion in the jointly guaranty of other Member States with lower ratings.

Third, the same Member States rightly claim that Eurobonds require as a prerequisite to their issuance to achieve a very high harmonisation of fiscal policies by all euro area Member States.

2. DIFFERENT EUROBOND PROPOSALS DESIGNED TO AVOID MORAL HAZARD

There are two precedents: in 1989, the creation of the “Brady Bonds” to solve the Latin America debt crisis and, in 1993, the proposal by Jacques Delors, of “Union Bonds”, whose repayment would be guaranteed by the Community budget. The newer proposals are the following ordered by date:

2.1 Gros/Micossi

The first proposal of a bond-issuing EU stability fund was made by Daniel Gros and Stefano Micossi in the Spring 2009 issue of *Europe's World* (3 March 2009). Both economists were the first to argue that investors had developed a strong preference for public debt, because governments can always force their central banks to print the money needed to meet their obligations, but this was not the case in Europe where no national government can force the ECB to print money. They realised that, on one side, there was a very strong demand for European bonds from investors to diversify away from the US dollar, and on the other side, Europe needed massive government capital infusions to prevent the crisis getting worse, mainly in the banking sector and in the euro area periphery.

This is the reason why they were the first to propose the creation of a massive European Financial Stability Fund (EFSF) that would be at least on the scale of the US TARP, around EUR 500-700 billion which will issue bonds on the international markets with the explicit guarantee of Member States to face the necessary crisis management and would be wound down after a pre-determined period, perhaps of five years. For global investors, EFSF bonds would be practically riskless as they would have the backing of all Member States. They both affirmed that until the EU does not develop a unified market for bonds denominated in euro, backed jointly by EU Member States, the euro cannot become a leading reserve currency with the present privileges of the dollar.

Setting up this fund with a common guarantee would not imply that stronger Member States would have to pay for the mistakes of the others, because at the end of its operations, losses could be distributed across Member States according to where they arose. In all likelihood, though, the fund would not lose, but rather make money because its funding costs would be much lower than those of individual Member States' fiscal stimulus and because its existence would stabilise European financial markets. They were in favor of using the EIB as the agency hosting the EFSF because its board of governors included the finance ministers of the EU Member States.

At 24 May 2010, more than one year later, an EFSF, with the same name and with a similar size to that proposed by the two economists, was created, but late, on an early morning of a Monday, after long urgent meetings over the weekend and under huge pressure from financial markets.

2.2 De Grauwe/Moesen

A second proposal for issuing Eurobonds has been made by Paul De Grauwe and Wim Moesen in the *Intereconomics* issue of May-June 2009. Both economists show that the dramatic increase in the spreads of some Member States debt would create huge distortions such as a growing perception of default, low response to fiscal stimulus and negative externalities and spillovers, making it extremely difficult to solve their banking crises and exit from recession. This situation could only be solved either by the ECB buying the debt of these Member States to reduce their high yields or, preferably, by issuing Eurobonds, collectively guaranteed by euro area governments.

They consider the EIB the institution better suited to issue them or even alternatively, directly by the euro area governments. In order to avoid that countries with lower spreads, especially Germany, object to Eurobond issues, they make the following proposals:

First, each euro area government would participate in the issue on the basis of its equity shares in the EIB. Second, the coupon on the Eurobond would be a weighted average of the yields observed in each government bond market at the moment of the issue weighted also by their equity shares in the EIB. Third, the proceeds of the bonds would be channeled to each member government according to the same EIB share weights. Fourth, each government would pay the yearly interest rate on its part of the bond, using the same national interest rate used to compute the average interest of the euro bond. Greece, for instance, would have to pay a yearly interest rate on its part of the outstanding bond of 5.7% while Germany would have to pay only 3.1%.

The advantage of this scheme is that Greece would pay the interest rate it faces today in the market, thus the incentive to free ride Germany would be very small or zero and Germany would pay the same interest it pays when issuing its own bonds, so it would not be penalised by a potentially higher interest rate. Why then Greece would participate if it keeps paying the same interest rate? Because it would avoid being shut out of the market and can continue to have access to funding without imposing a burden on other participants in the scheme.

Both economists alert about this system having two practical problems. The first is how to share the collective responsibilities underlying the bond issue. They would be the same that they already share when the EIB issues today in the markets. The second is that the yield of the euro common bond may differ from the weighted average of the yields of national bonds constituting the common bond as it happened with the ECU-bonds in the past. Nevertheless, given that the liquidity of the common euro bond would be much higher than in the individual national bond markets, the Eurobond would have a lower yield than the weighted average, so Member States with lower liquidity in their national bond markets will benefit from the lower yields that the higher liquidity of the euro bond produces.

2.3 Delpla/von Weizsäcker

The Blue and Red Eurobond proposal by Jacques Delpla and Jacob von Weizsäcker, published in May 2010 by Bruegel, is the most elaborated proposal known up to date. Both economists have come up with a design which avoids most if not all the Eurobond potential cons. Their main idea is to have both a senior and a junior debt tranche in the euro area Eurobonds. They call them Blue and Red Eurobonds.

The Blue or senior bond tranche will be constructed by pooling up to 60% of GDP of the national sovereign debt of the euro area Member States (which is considered, according to the Treaty, the maximum level up to which debt is sustainable or not excessive) under joint and several liability of all its members to ensure that it will be a triple A asset. This Eurobond will have a substantially lower yield than the weighted average of the national bond yields, given that the size and the liquidity of its market will be similar to those of the US Treasury bond.

This Blue bond will strengthen the confidence in the euro and will help to end the actual sovereign debt crisis. Moreover, interest rates on these Blue bonds will be even lower than those of the German Bunds today. From an investor's perspective, their joint and several liability will reduce the risk even further because defaults risks tend not to be perfectly correlated, lowering even more the yields on the Blue or senior tranche bond.

The Blue bond market would reach an amount of around EUR 5,600 billion which is about five times the current market size of the German Bund and close in size to the US Treasury

bond market which is around USD 8,300 billion. Greater size and liquidity bring down borrowing costs given that large public investors, such as central banks and sovereign wealth funds, greatly value safety and liquidity. Only the increase in liquidity could reduce the debt cost of the Blue Bond by 10%, which is equivalent to reducing the net present value of the debt stock by 10% as well. Assuming a legacy debt stock of 60% of GDP, the liquidity advantage generated could amount to an average net present value of 6% of GDP of the euro area Member States.

Government and public investors and large private investors in public debt, such as banks, insurance companies and pension funds not only invest in very deep and highly liquid bond markets but they also try to invest in highly diversified debt, so that the pooling of the debt of 17 quite different Member States reduces the default correlation risk and may win another added reduction to debt costs. Moreover, most of these investors need to diversify their investments away from the US Treasury bond market and away from the US dollar, so they can get a natural exchange rate hedge, given the very high inverse correlation between both currencies movements. These are the main reasons why the euro will never be able to compete with the US dollar as a leading world reserve currency if such a Blue bond market is not created.

The Red or junior bond tranche is constructed by the excessive debt above the 60% level of debt to GDP and it will be issued by the Member States themselves. In this way, the junior tranche would pay a much higher interest rate than the present weighted average, because of its higher risk of default and its larger illiquidity. The average cost of borrowing for each Member State would be higher, the higher its amount of debt rises above 60% of GDP and the more worrying its borrowing path.

By disentangling sovereign debt responsibilities within the euro area, the 'no-bailout' clause of the Treaty would become more credible not only *de jure*, but *de facto* since the higher rates of the Red bonds will send a warning signal to those Member States on an unsustainable fiscal path, discouraging them from reaching excessive debt levels above 60% of GDP and avoiding a situation like the present one, with high negative externalities and contagion to other Member States with a lower debt levels.

At the same time, it would be also less disruptive for a Member State issuing Eurobonds to default on its Red junior tranche, because the borrowing capacity of its senior Blue tranche would not be destroyed, as it would happen today. But from an investor's perspective the prospects of a less disruptive default on the junior tranche increases the risk of default, thereby calling for an additional risk premium, thus maintaining the Member State's incentive to avoid a level of debt close to default.

Moreover, the ECB will, most probably, take a prudent stance regarding the eligibility of Red bonds for its repo facility and, in order to qualify for the Blue bond tranche, national governments could be obliged to introduce a standardised collective action clause (CAC) in their Red bond borrowing, which would make any debt default or restructuring simpler and shorter.

Debt discipline would be encouraged because this model would bring down the cost of debt servicing at the margin, bringing down overall debt and reducing the cost of debt on the Red tranche and on the overall debt. It would also encourage Member States not to reach the 60% of GDP debt levels because they borrow much cheaper and therefore they can keep their debt levels more sustainable and lower than in today's situation.

The Blue and Red bond differential borrowing costs would help not only to give incentives to recover the credibility on the Stability and Growth Pact, but also to reduce the risk of a necessary bail-out of fiscally vulnerable Member States. Moreover, if necessary, the allocations of Blue bonds borrowing quotas could also be differentiated allowing fiscally

prudent members to borrow up to their 60% of GDP, but not as much for members reaching vulnerable fiscal positions, in order to increase their incentives to be fiscally prudent. As Blue Bonds imply a guarantee by all euro area national taxpayers, their allocation should be decided ultimately by national parliaments or by an Independent Stability Council which decisions would be compulsory.

2.4 Juncker/Tremonti

Finally, Jean Claude Juncker's and Giulio Tremonti's proposal was published on 6 December 2010 by the Financial Times. The importance of their proposal, which is similar to the Blue and Red bond above, is that it has been the only one which was officially rejected by Germany and France at the bilateral summit on 10 December 2010 in Freiburg, even if the President of the Euro-Group was one of the two proponents. Nevertheless, European Commission President Barroso promised to defend it speaking at the plenary of the European Parliament in Luxembourg on 15 December 2010 after knowing about its rejection by the heads of both leading euro area Member States.

Both important ministers propose to launch Eurobonds issued by a European Debt Agency (EDA), as a successor of the EFSF, to be created within one month by the European Council (the creation of EDA had been proposed previously by Yves Leterme, Belgium Prime Minister, on 5 March 2010). The EDA should have a mandate to issue Eurobonds gradually up to reaching an amount of outstanding debt equivalent to 40% of the total GDP of the European Union (not of the euro area) and of each Member State's GDP.

First, the EDA should finance up to 50% of issuances by EU Member States to create a deep and liquid market. In exceptional circumstances, for Member States whose access to markets is impaired, it could finance up to 100% of issuances. Second, the EDA should offer a switch between Eurobonds and existing national bonds. The conversion rate would be at par, but the switch would be made through a discount option, where the discount is likely to be higher the more a bond is undergoing market stress. Knowing in advance the evolution of such spreads, Member States would have a strong incentive to reduce their deficits.

These Eurobonds would halt the disruption of sovereign debt markets and stop present negative spillovers across national markets. In the absence of well-functioning secondary markets, investors are weary of being forced to hold their bonds to maturity and therefore ask for increasing prices when underwriting primary issuances.

With a single European market, primary market disruptions are in effect precluded, reducing the present emergency interventions by the ECB. This new market would also ensure that private bondholders bear the risk and responsibility for their investment decisions, providing clarity about a future permanent mechanism to deal with debt restructuring and helping restore confidence by allowing markets to be exposed to losses and ensuring market discipline.

Allowing investors to switch national bonds for Eurobonds, which might enjoy a higher status as collateral for the ECB, would help to achieve this market. Bonds of Member States with weaker public finances could be converted at a discount, implying that banks and other private bondholders immediately incur related losses, ensuring transparency about their solvency and capital adequacy. Eurobond markets would also help Member States in difficulty without leading to moral hazard. Governments would have access to sufficient resources at the EDA's interest rate, to consolidate public finances without being exposed to short term speculative attacks. They could honor all their obligations and avoid excessive interest rates on their borrowing that is not covered by Eurobonds.

Ultimately, the EU would benefit too, given that profits from conversion would accrue to the EDA, reducing effective Eurobond interest rates and avoiding that EU taxpayers and Member States under attack would have to foot the bill. All these benefits could be extended to Member States that remain outside the euro area.

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3. COMMENTS ON THESE PROPOSALS

1) The pioneer proposal by Gros and Micossi has proved very successful because they did anticipate, more than one year earlier, the design and creation of the present EFSF and also did anticipate the idea that the Eurobonds could exist with the creation of the EFSF (which are today issued by the EFSF). Moreover, they thought about the EFSF as a temporary fund to last a maximum of five years to treat crises management of the EU, not only the banking crisis but also the present EU periphery sovereign debt crisis and also that the losses of the fund would be distributed among the Member States according to their use. Finally, they were also the first to say that until the EU does not develop a unified market for Eurobonds, jointly backed by EU Member States, the euro cannot become a real leading international reserve currency.

2) The Eurobonds proposal by De Grauwe and Moesen is based on using the EIB as their issuer, their guarantee should be according to their participation in the capital of the EIB and their allocation should also be according to their same participation. But it is a very rigid proposal, given that it establishes that Member States pay exactly the same interest rates than before such a new scheme is created. Their proposal is penalising Greece and other Member States with weaker fiscal positions and is favouring members with better fiscal stances, to avoid any possibility of moral hazard. The only reason why Greece would join this scheme is because it avoids to be shut out from financial markets. The only benefit is that the liquidity of the Eurobond market will be much higher than that of the national bond markets, so that small Member States with lower liquidity would benefit more than those with larger size and liquidity.

3) The Juncker and Tremonti proposal is the only one of the four that may not reduce or avoid moral hazard, which is the most important issue for France and Germany in order to accept Eurobonds. The EDA only issues Eurobonds up to 40% of the total GDP of the EU, but these Eurobonds should finance up to 50% of total issuances, and, in exceptional circumstances, the EDA Eurobonds can even finance up to 100% of the issuance for Member States whose access to debt markets is impaired. This is the main reason why it may have been rejected by Germany and France because the rest of the EU members believe that these Member States with no access to debt markets may free-ride on them. Moreover, their proposal is for the whole European Union, not only for the euro area Member States, which makes their proposal more difficult to implement, given that it states that their benefits could also be extended to other EU Member States that remain outside the euro area.

4) The most elaborated and comprehensive proposal is that of Delpla and von Weizsäcker which seems to be the best and a more balanced option because it avoids moral hazard and has the highest chance of getting a consensus among euro area Member States. Therefore, it should deserve a serious debate at the next ECOFIN and European Council meetings as well as at the European Parliament. My only critique is that it proposes that national parliaments should decide the Eurobond allocation, which will be cumbersome and difficult. I would rather let this decision in the hands of an independent agency, also proposed by them, the Independent Stability Council (ISC).