Eurobonds

The European Union's (EU) responses to the sovereign debt crises of the past few years have met with only limited success. Emergency measures like the creation of the European Financial Stability Facility (EFSF) and the European Financial Stabilization Mechanism (EFSM) have satisfied the urgent need for financial support facilities but are merely symptom-management tools. More lasting legislative reforms intended to prevent another crisis from occurring, such as the "six-pack," fiscal compact, and "two-pack," focus extensively on improving the behavior of irresponsible borrowers but fail to address any of the deep structural deficiencies in the European financial system.

This brief presents the case for eurobonds as an alternative means of dealing with Europe's debt problems, one which has the potential to both dissuade profligate borrowing as well as mitigate Europe's systemic fragilities. It proceeds in four parts: the first provides an overview of the structural and behavioral problems at the heart of the sovereign debt crisis, the second and third show how eurobonds could ameliorate some of Europe's structural problems while incentivizing better fiscal behavior, and the fourth concludes by assessing the current state of play in the eurobond debate.

Three Problems

The European financial system faces three basic problems. First, banks' and governments' balance sheets are so interdependent that they are extremely vulnerable to one another's financial difficulties. Second, the lack of a "risk-free" asset that circulates throughout the eurozone means that skittish investors looking for safe assets are often compelled to move their capital into stable economies, necessarily causing destabilizing capital flight from more troubled countries. These more esoteric structural weaknesses have been revealed by the investor reaction to a third, more familiar problem – excessive borrowing by governments, firms, and households that has led to debt burdens large enough to spark widespread solvency concerns.

The first problem is a byproduct of a historically close relationship between governments and their banking sectors. Domestic banks provide the bulk of the governments' financing in exchange for sovereign bonds. Banks then use the bonds as high-quality collateral for obtaining liquidity from central banks and wholesale credit markets. In exchange, governments get a ready and liquid market for their debt. This relationship becomes a weakness when either the banks or government – or both – run into financial problems. In some instances, banks incur major losses that stress government finances. Ireland, where support to banks cost the government 25% of Irish GDP and nudged the country toward default, has been an extreme case of this.[1] In other countries, insolvent

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governments are the problem. This is the case in Greece, where haircuts on Greece's sovereign debt invariably hit Greece's own banks – which hold 67% of that debt – the hardest.[2] In effect, the interdependence between bank and government balance sheets creates a hard-wired channel for contagion.

The second issue concerns the particular way in which investors in European sovereign bonds seek safe returns at times of crisis. Prior to 2008, Greece, Ireland, Portugal, Spain, and Italy had each welcomed large private capital inflows. When the crisis struck, however, these capital inflows stopped or began moving in reverse (i.e., a "sudden stop"). The first sudden stops occurred in Greece and Ireland between March 2008 and early 2009. After a period of relative calm, the impending Greek bailout in Spring 2010 once again led to capital flow reversals – this time in Portugal as well as Greece and Ireland. Finally, amidst the messy negotiations of the second Greek bailout and increased uncertainty over Europe's ability to contain the crisis in the latter half of 2011, capital fled from Spain, Italy, and Portugal.[3]

These events are considered in more detail in the companion brief on Contagion and the European Financial Crisis but the basic explanation is straightforward. Holders of debt, growing concerned about their exposure to troubled European economies, moved their wealth into more secure assets. However, in the absence of a risk-free asset that circulates throughout the eurozone, investors looking for quality have been obliged to move their wealth across *geographic* lines in order to find it. Much of the capital that had flowed for years into peripheral economies – where interest rates had been higher and investment opportunities more plentiful – returned to lower-yield safe havens. In the worst cases, domestic capital also fled troubled countries.

This is very different from what takes place in the United States, where the flight to quality takes place across asset classes rather than geographic lines. Anyone concerned about their American investments can move into relatively risk-free US treasuries. The result, for instance, is capital flight out of Californian state debt, not out of California entirely. The geographic flight to quality in Europe is troublesome because it can starve an already-weakened economy of credit, driving up borrowing costs, and worsening the default risk on virtually all local debts. Rather than evaluate Greek securities on the basis of the individual borrower, investors ultimately evaluate Greek securities on the basis that they are Greek.

During the crisis, European leaders have generally risen to the immediate challenges these underlying problems have caused. The European Central Bank (ECB) has loosened its collateral requirements in order to accept distressed countries' sovereign bonds from banks despite low debt ratings, ensuring that financial sectors in distressed countries have had access to liquidity. Moreover, the EFSF and EFSM have helped to offset reduced private inflows by replacing them with official assistance. These efforts, however, only treat symptoms of the underlying structural problems.

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Unfortunately, policymakers also have misdiagnosed these fundamental problems by focusing so extensively on the problem of profligate borrowing. Although the attention to excessive borrowing is not misplaced, it risks oversimplifying the challenges to the eurozone. Governments in Greece and banks in Ireland indeed contributed to their own financial fragility by becoming heavily indebted; there would simply be no Greek crisis if Greece was not in debt. Yet the European effort to craft a lasting solution to the crisis has almost exclusively emphasized this one dimension of the wider crisis. With few exceptions, the major European policy response stresses debt-reduction above all other concerns by institutionalizing rules that would dissuade governments, in particular, from borrowing too heavily. The "six-pack," fiscal compact treaty, and "two-pack" – discussed at length in the briefing on Macroeconomic Policy Coordination in the European Union – are all variations on the austerity theme.

This approach is paradoxically both too narrow and too ambitious. By neglecting the issues of bank collateral or the geographic flight to quality, European leaders have avoided the wider structural problems that make European finance particularly vulnerable. Yet by attempting to resolve the situation through eliminating borrowers' tendency to get into too much debt in the first place, they have pinned their hopes on stamping out a behavior – sovereign fiscal irresponsibility – that is older than states themselves. Bad behavior primed the system for crisis; however, the severity of the resulting instability has been exacerbated by Europe's structural deficiencies.

Eurobonds and Structural Problems

The best solution to this constellation of problems may be to create an extremely low-risk asset to circulate throughout the entire eurozone. This is the basic idea behind a eurobond, or what the European Commission calls a stability bond. A semantic warning is needed here: European governments inside and outside the eurozone have long issued their own sovereign debt in instruments denominated in euros which are also known as eurobonds. However, the proposals discussed here are specifically for bonds which pool states' sovereign debts as well as – in most cases – the liability for repaying those debts.

The European Commission's November 2011 green paper on the feasibility of a jointly underwritten debt instrument presents three possible approaches to a eurobond.[4] The most ambitious of these envisions converting all member states' sovereign debt into collectively backed debt. In one fell swoop, this would entirely replace national debt markets with a single market for pooled European debt. The most cautious approach, on the other hand, would create eurobonds to circulate alongside national debt but make each country proportionally liable for its own share of the common debt pool. A third alternative calls for the conversion of a limited percentage of country's national debt into eurobonds under joint and several liability. States would retain sole liability for any debt above that limit.[5] Ultimately, while the specific construction of a common European debt instrument alters the cost-benefit calculus, any of the available options would result in at least modest structural upgrades to the European financial system.

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Each of the three proposals calls for the creation of a new class of euro-denominated debt securities that would provide banks with an alternative to holding domestic sovereign bonds. The most ambitious plan would completely decouple banks' balance sheets from the creditworthiness of their domestic governments by eliminating national debt altogether. Even the more tentative alternatives would at least give domestic banks the option of diversifying into common debt instruments which are less dependent on their home governments' credit risk. Nevertheless, because the more limited plans preserve a market for nationally backed sovereign debt alongside the market for eurobonds, home bias will likely still be an issue. Until it disappears, the special exposure of banks to a default by their home government will endure. The more national debt is converted into communal debt, the lower this exposure will be.

For their part, governments would become less reliant on their own banking sectors to provide a market for their sovereign bonds. In issuing eurobonds, they could borrow from a much deeper and more liquid market for funds. This alone would decrease the cost of borrowing by reducing the liquidity premium paid by states, particularly for smaller or fiscally troubled countries facing relatively thin bond markets.[6] Risky borrowers would additionally benefit from any arrangement that established joint or joint and several liability for common debt. For instance, the Greek government would be able to borrow at far lower rates if bondholders were confident that Germans would be forced to foot the bill for a Greek default. This does raise a serious moral hazard concern, which is dealt with in more detail in the next section. On the other hand, a eurobond with strictly proportionate liability, in which each country would only be responsible for its own share of the common debt in the event of default, would avoid the moral hazard problem but would also result in a smaller cost reduction for borrowers.

Perhaps most importantly, implementation of these proposals would mitigate the problem of a geographic flight to quality, though to different degrees depending on the option selected. If capital-holders in Greece, Ireland, Portugal, Spain, or Italy grow concerned about the safety of their investments, eurobonds would allow them to move their money into higher quality debt in the same country rather than into a different country altogether. This would relieve some of the upward pressure on borrowing costs for all borrowers in risky countries as well as obviate worries over the TARGET2 imbalances between EU member states. These benefits shrink as more restrictions are placed on the eurobond market, however. If the market is illiquid or the risk of holding eurobonds is too high, some investors will still flee to geographic safe havens in a crisis.

Eurobonds and Market Discipline

One of the largest objections to a common European bond is that joint debt would undermine pressure for fiscal reform. Otmar Issing, an early shaper of the euro, argued that a eurobond "is no cure for a lack of fiscal discipline; on the contrary, it would tend to encourage countries to continue on their wrong fiscal course."[7] This is consistent with the consensus among many European policymakers, particularly Germans and other northern Europeans, that the solution to the crisis must be the imposition of fiscal discipline. It is a valid critique; however, it applies to only the most ambitious eurobond proposals.

The conversion of all national debt into joint debt does indeed pose enormous moral hazard problems. In a worst case scenario, reckless spenders could continue with their irresponsible borrowing at reduced interest rates knowing that others would ultimately have to pay for their actions. In order to avert this outcome, the success of such an initiative would rest on extensive and effective multilateral policing of member states' fiscal policies. However, the fact that similar systems of multilateral restraint have failed in the past make this a somewhat unattractive option. At the same time, an extremely limited eurobond issued under proportional liability is not an adequate alternative. While it would eliminate moral hazard concerns, it would also not be as effective in solving the eurozone's structural dilemmas. For instance, an extremely limited common instrument backed by proportionate liability might remain riskier than holding German debt. In a crisis, the geographic flight to quality would consequently still occur across geographic lines.

This is where proposals that strike a balance between fully joint issuances and restrictive proportional liability, such as Jacques Delpla and Jakob von Weiszäcker's "blue bond" proposal, are particularly valuable. They show how eurobonds could actually strengthen market discipline by providing a market-based incentive to stay within certain borrowing limits.[8] The key is establishing a transparent limit on the amount of communal debt that countries could issue. A popular reference figure for such a limit is the 60% of GDP target identified by the Maastricht criteria as well as the Stability and Growth Pact. Borrowing up to this threshold would be branded responsible. The resulting "blue bond" securities would be issued under joint liability with senior status, ensuring the highest possible credit rating. Alternatively, any borrowing over the limit would be considered "excessive." The resulting "red debt" securities would be much lower quality: nationally backed, junior to the jointly issued debt, and with established rules for orderly restructuring and default.

By dividing all national debt into high-quality and low-quality tranches, the effective interest rates on responsible borrowing would fall while the cost of excessive borrowing would rise. This innovation possesses two major advantages. First, it would encourage markets to define the boundary between safe and risky assets in terms of debt level rather than nationality. Rather than viewing *all* Greek debt as junk, the market could apply that judgment to only the excessive portion of the debt. Second, the establishment of a transparent "excessiveness" threshold creates a market-based incentive for eurozone states to reduce their borrowing to the threshold value. Instead of relying solely on the combination of multilateral surveillance, rules, and sanctions to police deficits, a limited eurobond facility would build the incentive for fiscal discipline into the market's treatment of sovereign debt.

Further discipline would be ensured by the body entrusted with controlling the allocation of "blue bond" debt. The Delpla-Weiszäcker proposal envisions this as an Independent

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Stability Council (ISC), established by participating states, which would act as gatekeeper to the common debt pool. Participation in the scheme would only be permitted for countries that could demonstrate the credit-worthiness of their fiscal plans to the ISC. The body could also determine the allocation of jointly guaranteed funds based on national requests. This sort of arrangement reorients the incentives for fiscal stability away from the dubious “stick”-based system of fines and sanctions and toward a “carrot”-based system of benefits for those states that can prove themselves to be fiscally sound.

The State of Play

The eurobond discussion continues to hover around the periphery of the wider crisis-resolution debate. In principle, eurobonds have influential advocates such as Eurogroup president Jean-Claude Juncker and Italian Prime Minister Mario Monti.[9] However, its opponents are perhaps more powerful – and none is more prominent than German Chancellor Angela Merkel. Merkel, while not ruling out common debt issuance in the “distant” future, has stated that eurobonds are "exactly the wrong answer to the current crisis" and would make Europe into “a debt union and not to a stability union.”[10] Faced with categorical opposition by the head of the eurozone’s biggest economy, Juncker has resigned himself to the fact that “the time has not yet come ” for eurobonds.[11] François Hollande, the prohibitive favorite to become France’s next President who had briefly championed the eurobond cause, also quietly dropped his support of eurobonds in the face of deep opposition from Berlin. Eurobonds have once again been relegated to the back-burner.

The German objection to eurobonds, justified in part on Issing’s argument that they would lead to more reckless borrowing, is also based on self-interest and practical concerns. Any jointly issued European debt would likely be considered riskier than German’s own sovereign debt. The German Finance Ministry has estimated that a switch from bonds to eurobonds would force Germany to pay an 80 basis point premium over its present interest rates, at a cost to the taxpayer of €20-25 billion over the next ten years.[12] Furthermore, it is probable that the creation of a eurobond would require revisions to the Lisbon Treaty’s “no bailout” clause. This would be particularly problematic in Germany, where the Constitutional Court’s ruling on the legality of the Lisbon Treaty stipulated that no budgetary powers can be delegated by the Bundestag to Brussels. If the Court cannot be placated, the only alternative would be to rewrite the German constitution.[13]

For the moment, German opposition would appear insurmountable as long as Merkel remains in power with the support of the anti-eurobond Free Democrats (FDP). However, with the FDP now reduced to little more than a rump party and the opposition Social Democrats (SPD) favoring the creation of eurobonds, things may shift in the run-up to federal elections in 2013.[14]

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