EUROPEAN PARLIAMENT

DIRECTORATE GENERAL FOR INTERNAL POLICIES

POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICIES

ECONOMIC AND MONETARY AFFAIRS

EUROBONDS: CONCEPTS AND APPLICATIONS

BRIEFING NOTE

Abstract

Issuing Eurobonds means that all Member States become jointly responsible for anyone's debt. This would reduce the odds of a sovereign crisis but create a very serious moral hazard: fiscally-undisciplined governments would be encouraged to raise their debts, thus passing the associated risks and costs on to the fiscally-responsible governments. In general, mutualising debts help to deal with the threat of sovereign crises at the expense of discipline promotion. The Juncker/Tremonti proposal is clearly designed to deal with the crisis issue but, at least in its current schematic version, it encourages fiscal indiscipline. Solutions exist, but they need to be developped. The Delpla/von Weizsäcker proposal lies at the other end of the spectrum. It uses the idea of Eurobonds to promote fiscal discipline but it does not attempt to reduce the odds of a sovereign crisis.One would hope to have an intermediate proposal that would both alleviate the threat of crises and enhance discipline. No idea of this sort has been put forward so far. The problem is that crisis alleviation and the enhancement of market-based incentives to fiscal discipline are antinomic. Eurobonds are just instruments that can be used to achieve radically different aims.

IP/A/ECON/NT/2011-01 March 2011

PE 457.357 EN

This document was requested by the European Parliament's Committee on Economic and Monetary Affairs.

AUTHOR

Charles WYPLOSZ
Graduate Institute of International and Development Studies, Geneva

RESPONSIBLE ADMINISTRATOR

Doris KOLASSA
Policy Department Economic and Scientific Policies
European Parliament
B-1047 Brussels
E-mail: poldep-economy-science@europarl.europa.eu

LINGUISTIC VERSIONS

Original: EN
Executive summary: FR, DE

ABOUT THE EDITOR

To contact the Policy Department or to subscribe to its newsletter please write to:
poldep-economy-science@europarl.europa.eu

Manuscript completed in March 2011

This document is available on the Internet at:
http://www.europarl.europa.eu/activities/committees/studies.do?language=EN

DISCLAIMER

CONTENTS

EXECUTIVE SUMMARY

The idea of issuing Eurobonds is to make national debts of euro area countries identical and undistinguishable from one another. The idea is not new, and it is not surprising that it resurfaces at a time when markets sharply distinguish public debts, to the point that some governments face difficulties to borrow. Yet, there are good reasons for markets to distinguish among debts, and the higher interest rates that they require from countries that are perceived as fiscally-unsound act as a powerful incentive to restore budgetary discipline. This is why the existence of Eurobonds would significantly alter the euro area, potentially weakening fiscal discipline further. Any proposal to issue Eurobonds must explicitly address this moral hazard aspect.

The key characteristic of Eurobonds is that they mutualise national public debts. In other words, a group of countries, possibly all euro area Member States, undertake to share responsibility for each of them as far as debt service is concerned. With each government retaining sovereignty on its fiscal policy, the explicit guarantee creates an additional moral hazard problem. It is also risky since each country stands to suffer a loss should one party to the arrangement default, partially or totally. These losses may be significant. The proposals must also address these questions.

The Junker/Tremonti proposal envisages a European Debt Agency (EDA) that would pool national debts up to 40% of GDP, with many important details missing. It proposes that, at times of crisis, governments under market pressure can issue 100% of new debt through the EDA. This pretty much reduces the disciplinary effect of rising interest rates and therefore creates a serious moral hazard problem, with no complementary suggestion on how to compensate for it (solutions exist but need to be worked out). The proposal also includes the possibility for countries to issue debt through the EDA to buy back their own national debt. The usefulness of debt buybacks has been often studied and the general conclusion is that it only makes sense as part of a comprehensive debt restructuring program. The proposal is silent on this crucial aspect. In fact the proposal seems mainly designed to reduce pressure on governments, leaving markets to deal with the consequences and without any attention to the discipline issue.

The Delpla/von Weizsäcker proposal is more elaborate. In contrast to the Juncker/Tremonti proposal, it does not aim at avoiding debt crises, rather it focuses on enhancing debt discipline. Under this proposal, euro area governments would issue two different debt instruments: blue bonds up to 60% of GDP, which are mutualised and therefore undistinguishable; red bonds, which are strictly national and therefore distinguishable. This arrangement would create an incentive to bring public debts to 60%, since the interest rate would then be as low, or even lower, than German Bunds, while debt in excess of 60% is likely to carry significantly higher interest rates. This implies that governments that increase their indebtedness would face increasingly higher interest rates. If their debts go too far, they could well lose market access, i.e. face a crisis situation. In that case, the proposal's logic requires that there will never be any bailout, a stipulation that is not clearly stated.

1. WHY DO INTEREST RATES DIFFER?

The monetary union concerns a transfer of sovereignty to the ECB as the authority to conduct monetary policy, with the right to issue the common currency. As a result, there is a single euro interest rate for borrowing and lending from the ECB. Under normal circumstances, this single rate applies to borrowing and lending among banks that are considered as safe. Since the ECB borrows and lends for very short terms (normally less than one month), the single rate is only expected to apply to very short-term contracts. Beyond this horizon, interest rates are expected to reflect the perceived riskiness of the borrower. For instance, a bank may be seen as perfectly safe over the next few days but less than perfectly safe over a period of one or ten years. Thus the monetary union does not imply that all interest rates of similar maturities are equal.

This applies to borrowings by governments. Until the crisis, national public debts were carrying very similar interest rates. The spreads – the difference between a national debt and the German debt, which is considered by the markets are safest – did not exceed 15 basis points (0.15%) and were mostly lower than 5 basis points. In fact, observers – including the ECB – often remarked that the spreads were too low. But what do spreads represent? The difference between the British and German rates on, say, one-year bonds combines a currency risk and a default risk. The currency risk is the probability that the Sterling will depreciate relative to the euro over the next year multiplied by the expected size of the depreciation: if the probability is 50% and the expected depreciation is 20%, the country risk contributes 10 percentage points to the spread. The default risk combines the probability of a default and the expected size of the default. Within the euro, the currency risk is eliminated but the default risk remains.[1] The very small spreads reflected the perception that a default was highly improbable, yet not exactly zero. The crisis, of course, can be seen as a sudden revision in market expectations regarding this probability.

There is nothing wrong with that; in fact, this is exactly what was expected when the monetary union was launched. Since governments remain sovereign in matters of fiscal policy and debt issuance, each national debt is a different financial instrument that reflects the ability and willingness of the corresponding government to honor its commitment. The possibility that spreads could widen was actually considered as a crucial mechanism to enforce debt discipline, over and above the Stability and Growth Pact, which was known to be weak. This is precisely why the ECB has long been disappointed by what it saw as market complacency toward public finances in some countries.

It follows that there is a deep link between interest rate spreads and institutional mechanisms for fiscal discipline. The mechanism can be national, like the German constitutional debt brake, or collective, like the Stability and Growth Pact. The weaker these mechanisms are, the more important interest rate spreads become as an instrument for market-based discipline. Any proposal to weaken or eliminate spreads must be accompanied by better credible fiscal stability national or collective mechanisms.

Which is more effective, market or institutional discipline? The experience with market discipline is quite disappointing. The general view is that markets move too late and then too much, shifting from complacency to panic.

This observation applies to the current European sovereign crisis as well, and is exemplified by the way rating agencies decide too abruptly and considerably lower ratings on, say, ten-year bonds that they had long described as safe. Like most market participants, rating

[1] There remains the possibility that a country leaves the euro area but, in this case, its past debt is still denominated in euros. Switching to the new domestic currency would amount to a default since it would change the terms of the original debt contract.

agencies compensate their overlooking the risks with an exaggerated reaction. As the markets panic, they suddenly place borrowers under the obligation of immediately solving a problem that long been simmering and that is best addressed progressively.

The experience with institutional mechanisms is relatively short. A preliminary assessment, offered in Debrun et al. (2009) is that national rules have some effectiveness. The experience with the Stability and Growth Pact, the most elaborate collective undertaking so far, is not encouraging. As shown by Fatas and Mihov (2009) and Mongelli and Wyplosz (2009), the pact has not made a quantifiable difference during the first ten years of the euro's existence.

The conclusion is that neither institutions nor market discipline alone are likely to improve the quality of fiscal policies in the euro area. The implication is that both need to be kept in place and, whenever possible, improved.

2. WHAT ARE EUROBONDS?

Since bonds issued by national governments from euro area countries share the same currency but remain different, there is no unified bond market. This stands in sharp contrast with the huge market for US treasuries, which underpins the supremacy of the dollar as the single international currency. In the absence of federal debt, the euro is bound to remain a currency of secondary international importance, which is likely to weigh on the development of European financial markets. While political constraints currently prevent the emergence of a federal government, which would issue its own public debt, there are periodic suggestions that national governments could pool (some of) their debt instruments and make them identical.

To be identical, Eurobonds must share the same currency, as they already do of course, but they also must bear the exact same risk. To that effect, they must be guaranteed in the exact same way. Indeed, a bond is as safe as those that issue it. Many solutions are possible. They can be issued by a single agency, which is backed by member governments. The backing can be total or limited to a portion of the debt; in the latter case, the debt would likely command a premium over the debt issued by the government considered to be safest. Alternatively, they can be issued by national governments, which however formally and contractually commit to guarantee each others debts. In this case, the guarantee must be complete and the contractual terms must be exactly identical; otherwise national debts will remain different. An intermediate solution (blue and red bonds) is presented below.

Whatever solution is adopted, the key characteristic of Eurobonds is that they mutualise national public debts. In other words, a group of countries, possibly all euro area MemberStates, undertake to share responsibility for each one of them as far as debt service is concerned. With each government retaining sovereignty on its fiscal policy, the explicit guarantee creates a severe moral hazard problem unless it is appropriately dealt with. Why should any government exercise restraint when it knows that others will pay for its own excesses? That such proposals attract interest in the midst of the current crisis may seem surprising. In fact, there is a clear logic, albeit one that is fraught with serious risks.

The intention is quite explicitly to rule out sovereign crises. If the Greek debt was guaranteed by the other euro area Member States, there would be no crisis. That is true, but there must be a price. One price is the moral hazard issue. The answer is to tighten up institutional mechanisms apt to delivering fiscal discipline in the future. Indeed, we have seen a range of proposals to harden the Stability and Growth Pact, including new sanctions that should act as a powerful deterrent, for instance the suspension of voting rights for delinquent countries and a range of fairly inquisitive surveillance procedures. Solidarity thus comes along with some reduction in fiscal policy sovereignty.

The other price is financial. Governments that offer a guarantee must be ready to suffer occasionally some losses. Are the sums involved worrisome? The table below shows the cost that all other countries would suffer if one of them, indicated in column 1, would default on 25% of its debt (this is a level frequently observed in sovereign debt restructurings). The losses are measured as a percentage of the insuring countries, assuming that all 17 euro area countries contribute in proportion to their GDP. For all but five countries, the losses are less than 1%, with four others above 0.5%, the maximum penalty imposed by the Stability and Growth Pact , which was meant to be a powerful deterrent, and was never levied for fear of a grave political backlash. Of course, no one would expect Germany or the Netherlands to default, but other countries that could be, or currently are, on the market watch list, could impose losses that are quite enormous.

Loss imposed on other countries by a 25% default
(based on 2010 debt levels)

Germany	7.05%
Italy	6.04%
France	5.59%
Spain	2.08%
Netherlands	1.10%
Belgium	0.98%
Greece	0.91%
Austria	0.56%
Ireland	0.42%
Portugal	0.39%
Finland	0.24%
Slovakia	0.08%
Slovenia	0.04%
Cyprus	0.03%
Luxembourg	0.02%
Malta	0.01%
Estonia	0.00%

Source: AMECO, European Commission
Note: The table shows the ratio of 25% of the corresponding country gross debt to the sum of other countries' GDP.

Proponents of these measures must believe that it is possible to improve the effectiveness of the pact, much against what past experience has taught us. Opponents invariably observe that sovereignty is of the black-and-white variety: either each government and its parliament retains the last say on fiscal policy and restrictions will fail to make a difference as has been the case so far, or there are situations when governments and parliaments lose final authority. Proponents note that IMF programs impose some loss of sovereignty, but they fail to note that:

1) asking for am IMF program is never compulsory, countries can chose to default instead;

2) IMF programs are rare events that are triggered by occasional crises, not a permanent surveillance mechanism with built-in sanctions;

3) each IMF program is negotiated and tailored to each country's particular circumstances.

In short, IMF programs are temporary last-resort customised solutions, not the kind of permanent and automatic restraints that a hardened Stability and Growth Pact would entail.

The conclusion here is that Eurobonds would radically transform the euro area, unless they are set up in a way that seriously mitigates the moral hazard that they would create and unless they are capped to politically acceptable levels.

3. THE TWO MAIN PROPOSALS

Two recent proposals have attracted much attention. They are examined in the present section on the basis of the previous discussion:

- How do they affect market-based disciplinary effect? If they do, what are the countervailing institutional measures proposed?
- How are these bonds backed? How does the backing affect national sovereignty?
- Are there any serious moral hazard effects?
- Do the Eurobonds create a potential for significant costs?

Both proposals envisage that each country's debt would consist of two separate instruments. One is the same as is currently the case, a national debt guaranteed by each state. The other one is a Eurobond guaranteed collectively by all euro area Member States. The details differ and, as is often the case, they differ substantially.

3.1 The Juncker/Tremonti proposal

In a brief article published by the *Financial Times*, Ministers Juncker and Tremonti have proposed to create a European Debt Agency (EDA) to replace the EFSF as of 2013. This agency would have the right to issue debt up to 40% of national and collective GDPs. As a start, half of new national debts would be issued as EDA debt, thus building up the stock of Eurobonds over time. The proposal also includes a 'switch' procedure that would allow EDA to buy distressed national debts at a discount. Finally, distressed countries that cannot borrow, or only at high interest rates, would be allowed to issue 100% of their new debts through the EDA, at the EDA rate.

The proposal has two explicit intentions: to bring sovereign bond market stress to an end and to create a large and efficient bond market. As previously noted, the creation of a unified European bond market is desirable and this proposal would achieve that aim if the EDA benefits from a full guarantee of member governments. Such a guarantee is not explicitly stated, though; it is rather implied for the simple reason that the proposal is vacuous without a full collective guarantee. Without details on the mechanism that is envisioned, the proposal cannot be assessed fully.

Would the proposal prevent a sovereign debt crisis? Had we had an EDA in 2008, those countries that currently face high interest rates would have had access (up to 40% of GDP) to cheap borrowing. Still, the non-guaranteed portion of their debt would be under stress but they would have been eligible to the emergency window that would allow them to issue *all* the new debt through EDA. Thus the only stress that would be eliminated is the government's one, not the market's. This, of course, would create a serious moral hazard for the government could continue to borrow at low rates.

The proposal does not address this issue (more precisely, it summarily dismisses such an implication).[2] Some solutions exist, for example that newly issued EDA debt be swapped against national debt with a discount directly related to market prices.

[2] The relevant part is: 'An E-bond market would also assist Member States in difficulty, without leading to moral hazard. Governments would be granted access to sufficient resources, at the EDA's interest rate, to consolidate public finances without being exposed to short-term speculative attacks. This would require them to honour obligations in full, while they would still want to avoid excessive interest rates on borrowing that is not covered via E-bonds.' There is no argument as to why moral hazard is eliminated, except perhaps that the threat of higher

Nor does the proposal concern itself with the counterpart to the market discipline reduction that it creates. Virtuous countries would take on the risk of default of less virtuous countries, up to 40% of their debts (which exposures nearly double those shown in the table above). They are bound to require serious institutional safeguards.

In the absence of any explanation of how the collective guarantee is realised and without any proposal concerning institutional arrangements to promote fiscal discipline, it is impossible to evaluate the implications in term of national sovereignty. They are bound to be deep.[3]

The switch proposal is intended to finance buybacks by countries with large debts. Buybacks only make sense at time of distress – otherwise the country borrows the same amount that it pays back, while the idea is to buy back at a discount. Buybacks, therefore, only make sense as part of a debt restructuring strategy.[4] The Juncker/Tremonti proposal is silent on the question.

3.2 Blue and red bonds: the Delpla/von Weizsäcker proposal

The proposal by Delpla and von Weizsäcker is simpler. It does not aim at solving the crisis or, at least, at avoiding defaults. The intention, instead, is to enhance market-based discipline and therefore to lessen the demands on the Stability and Growth Pact.

The proposal is that euro area countries issue two different debt instruments; blue bonds that are explicitly collectively guaranteed, and red bonds that would remain national commitments. They suggest to cap the issue of blue bonds at 60% of each country's GDP.

The ideas is that blue bonds would be considered as perfectly safe by the markets and therefore carry an interest not higher than German bonds do. The blue bond market would be a large, deep and global market. The red bonds, on the other hand, should carry different interest rates, reflecting the market assessments of each government's creditworthiness. This proposal would eliminate neither government stress nor market stress. Quite to the contrary, the threat of default would force investors to be very careful.

Virtuous countries with debts below the Maastricht limit of 60% would face the best possible borrowing conditions. Less virtuous countries, with debts in excess of 60% of their GDPs, would face the whole brunt of market discipline *at the margin*, as they need to borrow more. This is crucial: countries with debts not much above 60% would have lower debt servicing costs than now and slightly higher marginal borrowing costs thus leaving governments with more room for maneuver. As debt levels move higher, presumably markets would impose higher costs on the red debts, which would effectively reduce considerably the moral hazard created by the pooling of blue bonds. An important aspect is that the blue bonds would be senior to the red bonds, so that governments would have to default first on the red bonds. As a result, all countries would have an incentive to bring their debts down to 60%, probably more powerfully so than with the Stability and Growth Pact, and without the need for any additional institution.

The Delpla/von Weizsäcker proposal assumes that markets will not be concerned by public debts below the 60% threshold. This is a reasonable assumption, but it depends on the collective willingness to let some red debts be defaulted upon. The proposal includes the

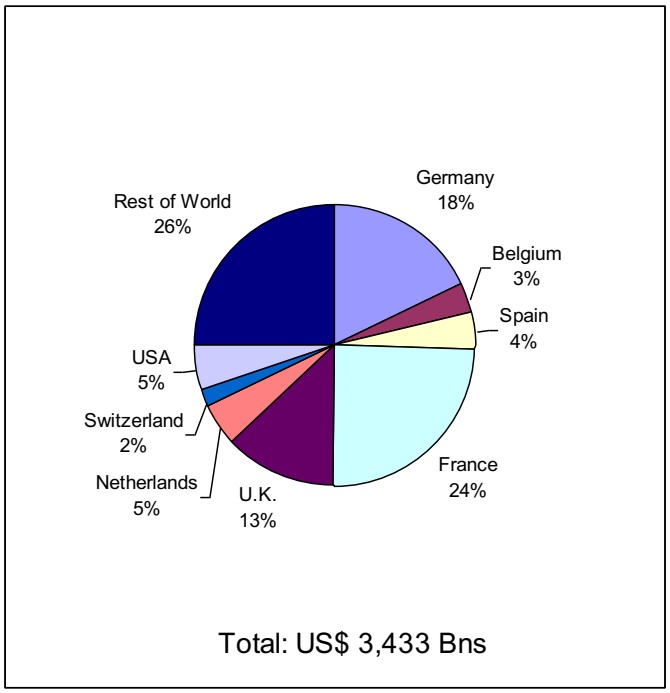
rates would properly incentivise each government. Since half of the new debt is protected, the incentive to avoid high rates is half of the current one.

[3] In comments on the Juncker/Tremonti proposals, Manasse (2010) develops this issue and concludes that 'the Eurobonds require a fiscal union where high debt countries lose (entirely or partially) their fiscal (and hence political) sovereignty.'

[4] This point, which has been made long ago by Bulow and Rogoff (1988), seems to be forgotten in current discussions.

requirement that red debts contain a collective action clause – an agreement on how debt defaults would be negotiated with creditors – that would make the defaults more orderly, but defaults are never perfectly orderly. One country's default could trigger contagions on others. This is precisely the threat that has led to the May 2010 rescues, the emergency creation of the EFSF and interventions by the ECB. The move is likely to have been inspired, partly at least, by the concerns of some (large) countries that some of their banks were seriously exposed to potential defaults by periphery countries. For instance, the figure below shows that in 2010, French and German banks held 24% and 18%, respectively, of the USD 3,433 billions of the combined Italian, Greek, Portuguese and Spanish public debts held worldwide by banks. This could happen again with red debts and prompt again a bailout that would blur the distinction between blue and red debts. It would seem crucial, therefore, that the no-bailout rule, whose interpretation has proven to be elastic, be redefined in such a way that it cannot be ignored under any circumstances.

Bank of holdings of public debts of the Mediterranean countries



Source: BIS
Note: The Mediterranean countries are: Italy, Greece, Portugal and Spain.

CONCLUSION

If very carefully structured, Eurobonds can help with the so-far unsuccessful efforts at establishing fiscal discipline in the euro area. This is what the Delpla/von Weizsäcker proposal aims to achieve. Using Eurobonds to bring the crisis to its end and to prevent future crises, as in the Juncker/Tremonti proposal, opens up a number of dangerous doors. The Juncker/Tremonti proposal would create major moral hazard, which could only be alleviated through a reduction in national sovereignty over fiscal policies. There may be good reasons to foster such a reduction in national sovereignty, including the aim of deepening Europe's economic and political integration. Such a deepening, however, should not be promoted indirectly by creating institutions bound to dysfunction, so that national sovereignty would have to be abandoned in an emergency situation. Crises often offer an opportunity to move lines, but the direction of such moves may the opposite of those intended.

REFERENCES

- Bulow, Jeremy and Rogoff, Kenneth; 'The Buyback Boondoggle', *Brookings Papers on Economic Activity* 2, 1988, p. 675-704.
- Debrun, Xavier, Hauner, David and Kumar, Manmohan S.; 'Independent Fiscal Agencies', *Journal of Economic Surveys* 23(1), 2009, p. 44 – 81.
- Fatas, Antonio and Mihov, Ilian; 'The Euro and Fiscal Policy', NBER Working Papers 14722, National Bureau of Economic Research, Cambridge, Massachusetts, 2009.
- Manasse, Paolo; 'My name is Bond, Euro Bond', Vox EU, 16 December 2010.
- Mongelli, Francesco Paolo and Wyplosz, Charles; 'The Euro at Ten: Unfulfilled Threats and Unexpected Challenges', in: Bartosz Mackowiak, Francesco Paolo Mongelli, Gilles Noblet and Frank Smets (eds), *The Euro at Ten – Lessons and Challenges*, European Central Bank, 2009.