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A Briefing on Eurobonds

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The recurrent debate on Eurobonds is often clouded by misconceptions. This Policy Brief clarifies their aims and possible forms, before discussing the key challenges for their introduction. It argues that, by ensuring market access to vulnerable Member States, Eurobonds can constitute a valuable tool to alleviate the eurozone crisis. To make use of their short-term potential, a conditional and progressive introduction of Eurobonds, starting with a limited scheme, seems the best achievable approach.

Introduction

Lively discussions on Eurobonds resurface whenever the outlook on the eurozone's future seems to worsen. The term 'Eurobonds' refers to common issuance of debt among eurozone countries. However, as the concept of Eurobonds is vague, public debate is often clouded by confusion on the possible aims and forms of such instruments.

The briefing firstly discusses the reason why Eurobonds are considered in the current policy debate (part 1). Subsequently, the Eurobond concept is defined, as well as its main design options (part 2). The key economic, political and legal challenges for their introduction will be discussed afterwards (part 3). Finally, possible next steps, reconciling the different views on the timing and conditions to be met, will be discussed in part 4.

1. Why Eurobonds?

Eurobonds were originally discussed as an advanced form of debt management cooperation offering potential efficiency gains[1]. By integrating the fragmented national public debt markets, Eurobonds' higher liquidity would **lower the average borrowing cost of the eurozone**. Ideally, rivalling US Treasury Bonds in their 'safe-haven' status, Eurobonds would furthermore **promote the role of the euro as a reserve currency**.

As the eurozone debt crisis led to significant and highly volatile interest rate spreads on

[1] Giovanni Group (2000), Report on co-ordinated issuance of public debt in the euro area.

German bonds, an additional argument in favour of introducing Eurobonds emerged. Common issuance of debt would **ease the sovereign debt crisis** by providing better market access for vulnerable Member States. The **stability of financial institutions** would also be reinforced in the short term, as Eurobonds would reduce their vulnerability to volatility in sovereign bond markets.

The **underlying assumption** for the short-term introduction of Eurobonds is that **countries under market pressure suffer - at least to a considerable extent - from liquidity problems**. Under this assumption, these countries can have structural problems, but are on a relatively sustainable path. Yet, market uncertainty and self-fulfilling prophecies of insolvency force them to pay very high interest rates on their debt. This makes their debt grow fast and can ultimately make it indeed difficult for these countries to reimburse their debt. This would turn the 'liquidity' problems into a 'solvency' crisis. 'Contagion' would in turn amplify the downward spiral, as investors would re-evaluate the risk of default of other countries facing similar difficulties. Consequently, current sovereign bond spreads would be explained, to a significant extent, by **'mispricing' due to unwarranted risk aversion and/or herd behaviour among investors**.

It is important to underscore that **Eurobonds neither have a direct impact on current account imbalances and primary deficits, nor on the promotion of growth**. Only in their purported capacity of restoring global confidence and stability in the eurozone can they help prevent insolvency and promote growth. Accompanying economic and budgetary policies remain therefore indispensable.

2. The 'Eurobond' concept

2.1. A definition of Eurobonds

'Eurobonds' (or 'stability bonds' in the Commission's wording) refer to **commonly issued public bonds guaranteed by eurozone countries**. The commonly issued debt thus involves the pooling of Member States' respective credit risks and guarantees. 'Weak' Member States, in the sense that they are currently facing strong market pressure and high interest rates, would thereby benefit from the credit worthiness and guarantees of 'strong' Member States. Issuance of Eurobonds would likely – but not necessarily – be centralised in a single European agency.

Eurobonds involve **sharing risks rather than sharing a 'common' debt**. Each country remains liable for repaying its own share of debt issued through Eurobonds. Only if a country fails to meet its payment obligations (i.e. it defaults) can creditors call upon the liabilities of other countries.

Eurobonds have some **similarities with existing** forms of jointly guaranteed debt issuances that finance **European lending programmes**. The Commission already borrows on the financial markets by issuing debt that is guaranteed by the EU budget (hence ultimately by all Member States)[2]. Moreover, the borrowing operations of the European Financial Stability Facility (EFSF) and European Stability Mechanism (ESM) are guaranteed by eurozone members.

[2] These borrowing operations are used for Balance of Payment Support, the European Financial Stability Mechanism (EFSM) and Macro-financial Assistance Programmes.

Eurobonds should, however, not be confused with **'project bonds'**, which **are fundamentally different instruments**; project bonds benefit from European guarantees, but are issued by companies. They further aim at facilitating the financing of specific infrastructure projects rather than general government expenses.

2.2. Key Eurobond design options

The many conceivable types of Eurobonds can be defined by some key characteristics.

Size of the Eurobond market

The size of the Eurobond market will depend on the **degree of substitution of national debt issuances by Eurobonds**. With **full substitution**, national debt issuances are discontinued and government debt **financing is entirely covered by Eurobonds**. In addition, past national debt could possibly be exchanged for Eurobonds.

With **limited substitution**, **national debt issuances continue to exist along Eurobonds**. A ceiling, expressed in relative terms, is generally used to determine the volume of debt that can be financed with Eurobonds (e.g. relative to a country's GDP). If recourse to the Eurobond scheme is not mandatory, some 'strong' countries would likely finance themselves exclusively through their national bonds. This might lower the credit rating of Eurobonds, as only 'weak' countries would issue debt through Eurobonds.

Under the limited substitution option, debt financing beyond the limit set on Eurobonds would be financed by national debt. The attached guarantees would - at least *de facto* but possibly *de jure* - make Eurobonds senior to national bonds. If the market pressure on the remaining national debt issuances proves 'excessive', Eurobonds' objectives of ensuring the borrowing resilience of 'weak' countries and preventing contagion would not be met.

Guarantee structure

With **'proportionate guarantees'** (also referred to as 'pro-rata' or 'several' guarantees) **each guaranteeing Member State is only liable for its share of Eurobonds liabilities**. Liability would be based on a specific contribution key, which can, *inter alia*, be based on the Member States' share in issued Eurobonds, ECB capital, EU budget or GDP. The EFSF and the ESM function on this basis.

With **'joint and several guarantees'**, **each country is liable** not only for its own share of Eurobond issuances but also **for the share of any other Member State** failing to honour its obligations. Such a form of guarantee would in theory be stronger than a 'proportionate' guarantee and would thus lower Eurobond borrowing costs.

If needed, the **Eurobonds' guarantee can be enhanced by other means**. This can involve legal **seniority** status (over national debt issuances) or **collateralisation** (with cash, gold, shares of public companies, earmarking on fiscal revenues, etc.).

Conditionalities

Participation of a Member State to the Eurobonds' issuances **can be made conditional on meeting specific criteria and/or the agreement by other participating countries**. Specific criteria could, for example, involve meeting strict fiscal and macro-economic thresholds, having adopted binding fiscal rules and not

being engaged in an EU/IMF adjustment programme. Besides specific criteria, participation in Eurobonds can also be conditional on the consent of other eurozone countries and perhaps the Commission.

Main proposals

The three most often cited proposals involve limited substitution of national debt and 'joint and several' liability, with a varying degree of conditionality.

Firstly, the **Blue Bond proposal** would replace up to 60% of GDP of national debt by Eurobonds, with the residual debt remaining national. The right of Member States to issue Eurobonds would depend on their compliance with the EU's fiscal rules.

Secondly, the **Redemption Fund** proposal would bring together all national debts above the 60% of GDP threshold into one fund. Debt in this fund would be financed by Eurobonds. Member States would then be obliged to redeem (i.e. reduce to zero) their part of the fund within a 20-25 year timeframe, after which the fund would expire.

Finally, the **Euro-bills** proposal would introduce common debt issuances with a short-term maturity (one year at most), which would then co-exist with long-term national debt. Under the proposal, the size of the Euro-bills market would be 10% of GDP at most[3].

[3] See 'Blue Bond/Red Bond' proposal (Delpla – von Weizsacker, 2010), the 'Redemption Fund' proposal (German Council of Economic Experts, 2011) and the 'Eurobills' proposal (Hellwig – Philippon, 2011).

3. Challenges to the introduction of Eurobonds

Considerable challenges would have to be overcome to ensure Eurobonds' political, economic and legal feasibility. They involve having adequate control mechanisms in place to address moral hazard concerns, balancing expected economic gains and losses, as well as ensuring Eurobonds' legal soundness.

3.1. Economic Union and moral hazard considerations

Despite their inconsistent and possible currently excessive disciplining effect, markets have demonstrated some efficiency at incentivising Member States to correct fiscal deficits and economic imbalances. The major and most often heard argument against Eurobonds is therefore that by removing the discipline imposed by markets on governments, Eurobonds would create so-called **'moral hazard'. Governments benefiting from lower yields might have the incentive to run inappropriate policies** leading to (further) public debt concerns and a lack of economic competitiveness; the negative consequences of which would ultimately be borne by others. With Eurobonds, the stronger the insurance provided to 'weak' countries - through the guarantees, collaterals, and credit worthiness of 'strong' countries - the stronger the moral hazard issue.

This **trade-off between insurance and moral hazard is inherent in any insurance scheme**. Taken too strictly and given the safeguards already provided by the revised EU economic governance framework, the moral hazard argument can tend to exaggerate the drive towards deficits and debt. Yet, to manage concerns and ensure political feasibility, any Eurobond

introduction would need to compensate for this alleged reduction of discipline by other mechanisms.

Different **solutions are possible**. In general, stronger disciplining mechanisms and safeguards within a **reinforced Economic Union** could pre-condition the introduction of Eurobonds. Solidarity implied by Eurobonds would come with better control of fiscal and macro-economic imbalances. This control is subsequently difficult without some political accountability. Steps towards a 'Political Union' would in turn be necessary.

In order to reduce moral hazard, the Eurobonds' design could also **limit the benefits obtained by 'weak' Member States**. Member States could be required to partly finance themselves with national debt, which would allow for market scrutiny of individual Member States. Alternately, the benefits of Eurobonds could depend on a Member State's credit worthiness or their respect of the economic governance rules (see 2.2). If properly designed, conditionalities might not only be able to reduce moral hazard, but could also become a driver for better fiscal and economic policies.

3.2. Economic considerations

Eurobonds would make economic sense if they were to lower the global average borrowing cost of eurozone countries, i.e. if the interest rate of Eurobonds is below the weighted average of participating countries' current interest rates.

The extent to which investors will value Eurobonds below this weighted average **depends on several factors**. The stronger the **guarantees** and other **collaterals**, the lower the perceived risk of default and hence the lower the interest rates asked by investors. **Liquidity gains** due to the larger size of the Eurobond market can be expected, but should, however, be quite limited[4]. Perhaps most significantly, by providing affordable interest rates to 'weak' countries, current excessive **mispricing due to speculation and market uncertainty would be limited**, thereby significantly lowering the average funding cost of the eurozone[5].

However, even when benefiting from important absolute gains, **Eurobonds' yield levels would likely still lie higher than the current very low bond yields in Germany** and other triple-A Member States. The lower interest rates that would be obtained by countries currently under financial market pressure would thus come at the expense of the most creditworthy countries. Eurobonds would thus, **indirectly**, result in **transfers from 'strong' to 'weak' eurozone countries**. The scale of such solidarity is inherently uncertain, as it depends on the yields of future Eurobonds.

However, the **losses for creditworthy countries can be compensated**. One option to work towards a 'win-win' situation is to redistribute the gains and costs of Eurobonds. By assigning different interest rates to each country, reflecting their relative performance, 'winners' of the scheme (e.g. Spain) would compensate 'losers' (e.g.

[4] Were it to reach the size of the US government bond market, one could expect rather limited gains, estimated between 10 and 20 basis points according to the Commission. See: Green Paper on the feasibility of introducing Stability Bonds, European Commission, COM(2011) 818.

[5] Again this expected gain crucially depends on the interpretation of the causes of the crisis, and of the interpretation of spreads divergence. See Part 1 on the rationale for Eurobonds.

Germany). Such a compensation scheme would, however, not work if Eurobond yields are too high. The Eurobond scheme could also be limited in time and volume, in order to cap the level of solidarity.

A **broader perspective on relative costs and gains would also help to reach a consensus**. In particular, this could involve the acknowledgment that extremely low interest rates in core eurozone countries are partly resulting from the crisis itself, as capital flight from the riskier periphery to the safer core takes place. More generally, the political feasibility of issuing Eurobonds will depend on 'strong' countries' own perception of the risks and costs associated with a protracted crisis, possible additional bailouts and/or a break-up of the eurozone.

3.3. Legal considerations

The legal problems related to the introduction of Eurobonds depend on the specific design. Ensuring the legal compatibility of Eurobonds benefiting from **joint and several guarantees** would be **more challenging than Eurobonds with 'proportionate'** (i.e. not joint) **guarantees**, as the former imply a greater level of risk-sharing.

On the EU level, the **no-bailout clause** (Article 125(1) TFEU) constitutes the prime legal obstacle. The clause prohibits the EU and the Member States from assuming the financial commitments of (other) Member States. Yet, Eurobonds would precisely imply that Member States agree to take over the commitments of other Member States when needed.

Policy-makers can try to **work around the restrictions of the no-bailout clause**. Firstly, the clause does not prevent the Member States from assuming EU commitments. Therefore, an EU body could be legally responsible for repaying Eurobonds, while Member States would in turn guarantee the EU body's financial obligations. Alternatively, Eurobonds could be defined as a *specific project*, for which the no-bailout clause provides an exception.

Working around the no-bailout clause is likely to leave some **legal uncertainty**, an option that creditworthy countries seek to exclude. Eurobonds **could** therefore **necessitate a modification of EU primary law**, or at least the commitment to do so in the near future. Making use of the simplified revision procedure is conceivable, but would still require ratification in all Member States. The procedure can furthermore not lead to an increase in the EU's competences and would hence likely lead to an intergovernmental approach. The alternative is a full-blown Treaty reform. This tends to be a drawn-out process, but can be accelerated if needed.

Besides the legal issues on the EU level, **Eurobonds also pose problems with regard to German law**. The German Constitutional Court ruled that the country cannot participate in a permanent mechanism in which it assumes the liability for other Member States' voluntary decisions. However, the Court's verdict leaves some room for Eurobonds, as long as the German liability is precise, limited in size, and subject to regular approval by the German Parliament[6].

[6] Federal Constitutional Court of Germany, Ruling of 7 September 2011, Case 2 BvR 987/10.

4. Steps towards Eurobonds

Major differences exist among Member States on if, how and when Eurobonds should be introduced. Especially the timing is a matter of vivid disagreements.

Some advocate the **short-term introduction** of Eurobonds. Such a move would be of major use in addressing the ongoing crisis, although it would be difficult to address all the aforementioned challenges. Despite the potential advantages, the prompt introduction of Eurobonds seems politically difficult.

On the other end of the spectrum is the idea of introducing **Eurobonds as the conclusion of an Economic and Political Union**, requiring long-term reforms. This approach is politically the most feasible. Yet, the mere agreement on a possible introduction of Eurobonds in the long term will not help address the ongoing crisis.

Given the limits of both the short-term and long-term views, a **precise roadmap** emerges as **the best achievable option**. Such a roadmap would include a timeline and conditions for a gradual introduction of Eurobonds. A first tangible step could consist in a **pilot project** whose limited size, guarantees and/or maturity would reduce concerns linked to Eurobonds[7]. By offering a limited short-term alternative source of financing to countries under market pressure, it could prove useful in mitigating the current crisis. If the pilot project were to have encouraging results, it would pave the way towards an Economic and Political Union and a fully-fledged system of Eurobonds.

Conclusion

So far, the EU has proven ineffective at managing the risk that self-fulfilling prophecies of insolvency lead to an unsustainable rise in a Member State's borrowing costs. The limited size and strong conditionality of the assistance mechanism (EFSF/ESM) constrains its capacity at preventing this risk. As for the ECB's reluctant interventions, they have shown their limits in restoring confidence and cannot substitute for a coherent and concerted political response to the crisis. The lack of an adequate response to the intensifying liquidity problems further aggravates the crisis and increasingly puts the sustainability of the common currency into question.

Eurobonds can be part of a comprehensive response to the crisis. They can help 'weak' Member States retain access to financial markets. This would in turn improve their outlook and reduce the risk of contagion to other Member States. However, eurozone countries would still crucially need to address the root causes of the crisis, i.e. unsustainable fiscal policies and/or major economic imbalances. Yet, Eurobonds would offer the time and means to carry out the necessary reforms. Moreover, participation in Eurobond issuances could be made conditional on compliance with European economic governance rules, thereby supporting the implementation of these rules.

Despite the immediate advantages of Eurobonds, the political feasibility for their swift introduction seems limited. However, if Eurobonds were only to be considered as a long-term possibility, when an eventual Economic and Political Union is achieved,

[7] Such a roadmap could include elements of the draft report by the European Parliament, although other options are also conceivable (notably a reform of the ESM). See: European Parliament, 2012, Draft report on the feasibility of introducing Stability Bonds, 2012/2028(INI), 4 June.

their potential at restoring confidence in the eurozone would be lost.

Taking into account the limits of both the short-term and the long-term perspectives, the best achievable outcome is a gradual approach. This should consist in the commitment to work out a clear, conditional Eurobonds roadmap, whose most immediate step would consist in a limited Eurobonds scheme. Such a scheme should allow for affordable market access to countries under financial market pressure, while simultaneously not stretching solidarity beyond what is deemed acceptable given the current state of economic and fiscal integration.

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