Can eurobonds solve EMU's problems?

August 2011

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Completion date: 10 augustus 2011

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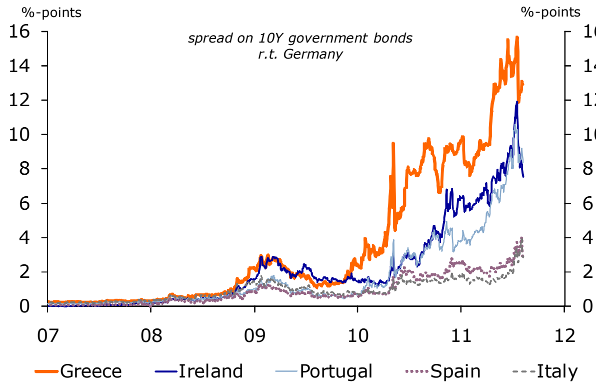
Crises, solutions, more crises...

Since the eruption of the Greek budget problems in 2009, the euro is lurching from crisis to crisis. European policy makers are struggling to find a solution for what in the press is nicknamed "the European debt crisis". Although Europe's public finances indeed have deteriorated substantially following the financial crisis of 2007/8 and the resulting recession, on average public debt and deficits in EMU are relatively low when compared with the United Kingdom, The United States and Japan. EMU's real problem is that small member states with serious financial problems, for example Greece, can infect the whole eurozone, in the process endangering the euro's bare existence. This points to a design flaw in the euro, which should be repaired.

Figure 1: Spreads within the eurozone



Source: EcoWin

The ultimate answer, of course, is to complement the Economic and Monetary Union (EMU) with the creation of a political union. This, however, is completely unrealistic at the present time, with political support for European integration at a low ebb. Nevertheless the political will to keep the euro intact is still exceptionally strong, as is amply illustrated by the string of rescue packages that have been presented over the last year, most recently on July 21th, 2011. This is certainly good news, as the costs of (partial) failure of the euro would be extremely high. However, the solutions adopted so far are far from convincing. Although they initially were successful in addressing the acute market panic that started to spread in the markets, the relieve proved to be short-lived. The most recent set of announced measures failed to convince the markets that the EMU is finally out of the danger zone. One of the reasons is that implementation of the measures, especially the larger role of the EFSF, will take months. Against the background of the downgrade of US public debt by Standard & Poor's and increasing fears of a global slowdown,tensions within the eurozone quickly reappeared. This is illustrated by the spread of the weaker countries over German Bunds (figure 1). Only after the ECB started to buy Italian and Spanish government bonds on Monday August 8th, the intra-EMU spreads started to decline.

From 2010 onwards, a flurry of initiatives were undertaken (Eijffinger, 2011). That year saw a.o. the birth of the European Financial Stability Facility (EFSF). This newly established institution supports the weaker member states in funding their financing needs. In doing so, it issues bonds in the international capital market, guaranteed by the stronger member states. As such, it is the first, albeit hesitant, major step towards central funding of public deficits of individual countries. I have advocated such a move for decades (Boonstra 1991, 2005, strengthening of the Stability and Growth Pact (SGP), which must, to that end, 2009), but it has until recently been seen as an absolute political no-go area. And although recently a range of proposals had been published on the topic, most offered solutions hesitate to cross the border and draw the conclusion that as long as European public bond markets remain fragmented along national lines, the EMU will remain in the danger zone. Therefore, they all overlook a simple, relatively inexpensive and effective solution: central funding of all deficits of all of EMU’s members States with a cross-guarantee of all participants for all their public debt, in combination with a stronger and effective stability and growth pact is the only way to fundamentally solve EMU’s problems, short of full political union.

What should be done?

Although the focus of recent discussions has been on the fiscal mismanagement by a number of its member states, EMU’s problems of course are wider and deeper. First, fiscal discipline is not strong enough. This should be cured by the introduction of the European Semester and a strengthening of the Stability and Growth Pact (SGP), including automatic and more effective sanctions. These are very important elements, but it is not enough. Countries such as Ireland and Spain played by the rules of the SGP, but nevertheless ran into problems because of the bursting of a huge property bubble. Cyprus was downgraded by Moody’s (and was immediately punished in the marketplace by seeing its bond yields rise) after an explosion eliminated 50 percent of its power supply. Whatever the strictness and effectiveness of a renewed SGP, one simply cannot exclude that countries may run into financial problems. Therefore, Europe also needs an automatic and effective default mechanism for countries in problems, preferably in a way that does not need to bother the taxpayers every time a country faces problems.

A further problem is that financial markets have done an extremely poor job in disciplining policymakers. Between 1999 and mid-2008, financial markets (and rating agencies!) failed to differentiate the credit qualities between government bonds issued by the stronger countries (such as Germany, Finland and The Netherlands) and those from weaker countries (e.g. Greece, Italy and Portugal). Only after ‘Lehman’ they woke up from their lethargy with vigour. This is harmful in two ways. First, by ignoring deterioration of the public finances of the weaker countries, these harmful developments could continue during a relatively long time. As a result, the problems grew larger and larger, until the weaker countries became extremely vulnerable. Once the change in sentiment happened in full force, these countries were immediately faced with extremely high interest rates which, if continued for a prolonged period, will push them towards insolvency. This situation can only be solved when countries can be sheltered form sudden swings in market sentiment, but in a way that improves market discipline or substitutes this with a more effective disciplinary mechanism.

Can the issuance of eurobonds solve these problems?

To answer this question, let us first establish what a solution should offer. A successful introduction of eurobonds should contribute to the better functioning of the EMU in the following ways:

1) Fiscal discipline: eurobonds must contribute to strengthening the enforcement of budgetary rules, i.e. those from the SGP.
2) Benefits for both strong *and* weak Member States: this is very important politically, as a eurobond proposal willonly succeed if there is a broad political support.
3) Market stability: the market for eurobonds will be larger and more stable than national markets, sheltering individual countries from large swings in market sentiment. Markets should be able to correctly and gradually discipline governments for good and bad behaviour, instead of acting very erratically as described above. If this is not possible, failing market discipline should be replaced by a better internal disciplining mechanism.
4) Effective and self-financing resolution mechanism. Under the assumption that once in a while a country will run into financial problems, it should be possible to smoothly reschedule its debt (under strict conditionality) without bothering taxpayers in the other member states. Ideally, a eurobond system finances itself via an insurance mechanism.
5) In addition, it would be helpful if the issuance of eurobonds would contribute to the creation of a larger and deeper European public bond market and the strengthening of the euro's position as a reserve currency.

Do recent proposals fulfil these criteria?

The recent rescue package of 21 July 2011, in spite of all of its merits, does not fulfil the criteria we have formulated for eurobonds. It does not fundamentally stabilise markets, it is not self-financing (to the contrary, taxpayers are bothered time and again) and, apart from the immense benefit of saving EMU at least for the time being, has no visible advantage for the stronger countries. It has a highly improvised character. Important, however, is the broadening of the scope of the EFSF, which has more flexibility to act pro-actively in order to stabilise EMU's financial markets. From this perspective, it certainly is an important step in the right direction (including point 5).

Other proposals that recently received media attention came from De Grauwe and Moesen (GM, 2009), Delpla and von Weiszäcker (DW, 2010) and Juncker and Tremonti (JT, 2010).[2] GM propose the issuance of eurobonds either via the European Investment Bank (EIB) or by the national governments themselves. These bonds should be backed by "the eurozone governments which have the

[2] A more thorough analysis of the proposals by GM, DW and an earlier version of my plan (Boonstra 2010) can be found in Eijffinger (2011).

taxing power to back up such a guarantee". Each eurozone country should participate in the issuance, with a share that is based on its equity share in the EIB. The interest rate (coupon) on the eurobond would be a weighted average (using the same weights) of the yields observed in their individual bond market at the moment of the issue. The proceeds of the bond issue would be channeled to each government, again using the same weights. Each government would pay the yearly interest rate on its part of the bond, using the same national interest rates used to compute the average interest rate on the euro bond. To prevent free rider behaviour by the weaker members, each country would pay the same interest to the EIB as it would pay in the markets. Note, that this feature can be explained by the time of their publication (early 2009), when there was already some unrest in the market, but before the spreads between German and Greek, Portuguese and Irish (and more recently also Italian and Spanish) government bonds reached historic heights.

The GM proposal is very limited in its ambitions. The most important benefit for the weaker countries is, of course, guaranteed access to liquidity, but it does not shelter them from sudden swings in market sentiment (and the resulting volatile interest rates). If a country would face prohibitive yields in the market, in GM's proposal it would still face an excessive interest bill to be paid to the EIB, threatening to make its public debt unsustainable. Therefore, it does not strengthen market discipline and it brings only limited benefits for the member states. However, it does create a new and large (and therefore very liquid) market segment of eurobonds.

The proposal by DW, in contrast, is more ambitious. The core of their proposal is as follows: they propose that EMU[3] countries pool up to 60 percent of GDP of their national debt under joint and several liability (a cross-guarantee of all participating countries) as senior sovereign debt (blue debt). Any debt above this limit would be issued by the members on their own behalf (red debt). This would guarantee funding and decline funding costs for the part of the debt below the SGP ceiling. Markets could exercise discipline on the remaining debt. This proposal guarantees all member states funding for the core of its debt against reasonable terms. Even if a country would have to default on its red debt, it would only touch a part of its public debt and remain limited in scale. It also introduces the right incentives as one may expect that the closer a country is to the 60% level, the lower its interest costs on its red debt will be.

When confronted with the above criteria, however, some points remain. The proposal still counts on the markets for disciplining governments, which, as experience teaches us, is an uncertain factor. As a result, countries still are vulnerable for swings in market sentiment, albeit for a limited part of their debt.

[3] DW speak of 'EU countries', but it is not clear from their proposal what the position of non-EMU members is.

This proposal also brings limited, although non-negligible benefits for the stronger countries. These consists of two elements, viz. the increased stability of the eurozone, which will result from the blue bonds, and lower funding costs that may be expected from the improved liquidity of the blue bond market. This market segment, with a AAA rating and accruing to a maximum of 60% of EMU GDP, will dwarf the individual bond market of even the larger EMU members. Therefore, the competitive position of the euro as a reserve currency will certainly be strengthened. Finally, the DW proposal is not self-financing. In case of (partial) default of a member, the other countries will have to bring financial support.

In a newspaper article JT present a proposal to establish a so-called European Debt Agency (EDA) in order to finance member states' financing requirements by the issuance of 'E-bonds'. The EDA would reach ultimately an amount of 40% of European GDP. It should also offer investors a switch between 'E-bonds' and existing national bonds. Governments of all member states in EMU would be offered access to funding at the EDA interest rate. This is of course very beneficial for the weaker countries, but offers no benefit for the stronger countries at all. The technicalities of JT's proposal are not worked out in detail. Their plan would help to create a large and liquid market in 'E-bonds', which would lower average funding costs and strengthen the competitive position of the euro. However, it does not strengthen fiscal discipline and the benefits for the stronger countries are unclear. Moreover, it is unclear on which ground they claim that their proposal does not lead to moral hazard.

Central financing of all EMU deficits would do the job

All current initiatives and the discussed proposals have the effect of further fragmenting Europe's public bond markets. Therefore, markets are still able to push individual countries into acute liquidity shortages. And every new recurrence of a problem gives rise to the same questions. Is support required, and if so, how much? And on what terms? Who is going to pay?

The answer can be found in a move towards financing all government deficits within the EMU via a central agency. This will end the fragmentation of EMU's public bond markets. This step is necessary but insufficient. The central agency, referred to in this article as the EMU Fund, raises the funds required on behalf of the EMU as a whole and assigns them to the individual member states. It does so, however, while applying a surcharge mechanism. This is the second step. The interest due from the member states on the funds they obtain from the EMU Fund will depend in part on the position of their government finances. The larger their government deficit and/or the higher their government debt, the higher the rate they will be charged. Slowly deteriorating public finances will be reflected in gradually increasing surcharges. Individual member states are, however, shielded from acute fluctuations in market sentiment. The third step is the

strengthening of the Stability and Growth Pact (SGP), which must, to that end, be provided with effective, gradually more stringent sanctions. These should preferably not take the form of fines. Political sanctions, such as the loss of voting tights in the ECB and/or the council of Ministers, are more keenly felt by policymakers and easier to effectuate. The EMU Fund can also impose additional terms for lending (as is being already done) if a country's performance slips further.
This combination of steps can be applied to stabilise EMU, without surrendering too much national sovereignty. It also offers several evident benefits for all countries. Everyone stands to benefit from the formation of a very large and liquid common bond market. The European Central Bank will no longer have to buy up bonds of individual member states, meaning that the present undesirable interweaving of monetary and budgetary policy can be ended. Weaker countries will be shielded from fluctuations in market sentiment within EMU and extremely volatile interest rates. And strong countries will not find themselves facing a problem every time a weaker country flounders. Countries that are out of line will be gradually confronted with rising financing costs. Consequently, an extended period of *free riding* by weak countries on the creditworthiness of stronger member states of the kind witnessed in the period 1999 – 2008 will no longer be possible. And if things nonetheless unexpectedly go wrong in a member state and its debt needs to be restructured, it will be clear that the EMU Fund will conduct negotiations and what the rules of the game are. Moreover, instead of paying higher interest to investors, the weaker countries will have paid a surcharge to the EMU Fund. As a rule the EMU Fund will always operate at a profit, which can be added to the Fund's reserves. Therefore, this fund will be able to build up a financial buffer, to act as an insurance against future financial problems, which makes this solution completely self-financing.

As an added advantage of this construction, its terms will only have to be negotiated once, namely when the fund is put in place. The SGP agreements will also have to be tightened, but they already have to be anyway. The technical aspects of the EMU Fund are very simple. The political hurdles that have to be overcome appear to be higher at first sight, as the benefits of the EMU Fund are abundantly clear for financially weaker countries, but initially less evident for the stronger countries. Germany in particular will need some convincing.

It is already the case today that the creditworthiness of the eurozone ultimately depends on that of the largest member states, i.e. Germany and France. That is why it is best to establish in advance that these two countries will, by definition, not have to pay a surcharge to the EMU Fund. Countries whose government finances are in better shape than those of Germany and France will pay no surcharge either and benefit from the improved liquidity. If this proves to be politically unacceptable, it is also possible to link the surcharge to the performance of a country against the SGP-criteria.

Participation should be voluntarily, but once in, you cannot go out. The simplest way of introducing the EMU Fund would be for France and Germany to agree with each other to adopt central funding of their government deficit with a cross-guarantee. Other countries will then be given the opportunity to join them, subject to appropriate terms. The advantages of participation and especially the drawbacks of non-participation will soon be evident, making the rest to soon follow suit quickly. However, an exception should be made for the countries that currently face serious problems and receive support (Greece, Ireland and Portugal). Their entrance should be delayed until the fears of their acute default have disappeared.

Setting up an EMU Fund cannot solve all problems of the eurozone. It does not absolve policy makers from their obligation to put their government finances and economies fundamentally in order. But it introduces the right incentives and it can give countries time to put their affairs in order without the eurozone lurching from one crisis into the next. Above all it will help to consolidate the euro for the future. All it takes is a little creativity and courage.

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Colophon

This Special is a publication by Wim Boonstra, head of the Economic Research Department (ERD) of Rabobank Nederland. The view presented in this publication has been based on data from sources we consider to be reliable.

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