TIGER

TRANSFORMATION, INTEGRATION and GLOBALIZATION ECONOMIC RESEARCH
CENTRUM BADAWCZE TRANSFORMACJI, INTEGRACJI I GLOBALIZACJI

TIGER **Working Paper Series**

No. 124

Euro Sovereign Debt: Would a Single European Bond Work?

Mario Nuti[1]

Warsaw, February 2011

[1] D. Mario Nuti, Sapienza University of Rome, email: dmarionuti@gmail.com, Website: http://sites.google.com/site/dmarionuti/, Blog "Transition": http://dmarionuti.blogspot.com/

Monsieur Trichet Is In Denial

On 27 January in Davos at the World Economic Forum the European Central Bank President, Monsieur Jean-Claude Trichet, stated boldly that “the euro is not in crisis”. He must have felt duty-bound to say that in an attempt to reassure international financial markets, regardless of what he really thought. If he actually believed what he said, then Monsieur Trichet is in denial, which is a poor foundation both for a fruitful discussion of the current crisis of the euro and for progressing towards its solution.

Of course, if one looked exclusively at the current exchange rate between the dollar and the euro and its recent trend, one would get the false impression that there is no crisis. On 29 January the euro stood at $1.37, a higher rate than before the Greek debt crisis erupted in February 2010 ($1.33), and much higher than the $1.18 rate to which it plunged in early May 2010 (and even that was 1cent higher than the initial exchange rate of 1.17 with which the euro started life in 1999). The euro recovery, however, was due primarily to the US Fed injecting $600bn liquidity over 8 months, compared with the more conservative restrictive policies of the ECB, and to US economic prospects being poorer than anticipated. After peaking at $1.42 last November, the euro fell again under $1.30 repeatedly (even a fortnight ago) with contagion spreading from Greece first to Ireland, then to Portugal, then threatening Spain.

Interest rate differentials

Beside the exchange rate increased volatility, and the downgrading of national credit ratings, a tangible and accurate measurement of the sovereign debt crisis of the euro is given by each country’s interest rate differential with respect to German bonds (usually taking 10-year bonds), the current yield on existing stock determining the rate at which the countries can borrow to rollover old debt or incur new debt. The spread over the German Bunds (whose yield has also risen as a result of the crisis, for fear of German exposure to baling out possible defaulters) has risen on average and significantly widened across countries over time, especially since the Greek crisis, and is now at record levels, higher than last May. Usually a 2% differential is regarded as the danger level; today Spain is just over, Italy just under that level; Portugal has almost 4% differential, Ireland over 6%, Greece 8 and a half per cent.

At interest rates higher than national growth rates (whether in nominal or real terms, as long as both are measured in the same way) national debt must increase relatively to GDP; debt is unsustainable and default looms. Even on the funds provided by the EFSF (the European Financial Stabilisation Facility set up last May) Greece and Ireland pay 5.8%, a rate lower than their market rates but higher than sustainable and signalling European lack of confidence in these countries’ ability to repay. Rescheduling of Irish and Greek debt – with lengthening of maturities and inflicting a haircut on investors – is now on the cards.

It is true that a recent bond issue by the EFSF was five times over-suscribed, but this was mostly “spurred by Basel III capital rules” set by the BIS, according to which AAA-rated sovereign bonds like those of EFSF “have a risk-weighting of 0%, which means that investors effectively don’t need to hold capital against it”. And that rating involves the EFSF over-collateralising its bonds reducing its operational capacity, and even EFSF bonds are subject to risk (for instance from the downgrading of one of the participating countries, which would require further capitalisation, see Klaus Regling, *Eurointelligence.com* 27 January).

Euro congenital vulnerability

The ultimate source of euro vulnerability is its premature birth. The single currency was supposed to be the *crowning* of the economic integration process, *after* political and fiscal union, *after* the unification of labour and social policies and, come to think of it, after a common foreign policy and a common army (though these *could* wait). Instead of which the single currency has been used to promote the so-called *finalité politique*, i.e. that political union that should have been the *pre-condition* of the euro. This is like a person buying clothes that are too tight and do not fit in the hope that this might facilitate slimming, by forcing one to diet: it does not work for me, it did not work for Europe. The fiscal constraints imposed by the Maastricht Treaty and the Growth and Stability Pact, 3% public deficit and 60% public debt, have not been observed by too many countries for too long (including Germany and France, who were first to violate the 3% ceiling), to be treated as substitutes for a fiscal union. Thus the initial fall and convergence of interest rates that occurred after the introduction of the euro have been reversed. The global crisis has lowered tax revenues and raised public expenditures, not least for rescuing financial institutions. Europe has reacted too slowly and inadequately to the sovereign debt crisis over the last year; European leaders have spoken with dissonant voices, often making perverse announcements, whether from ineptitude or malice.

Can the euro crisis be solved, or at least be significantly alleviated, by the issue of a single European bond covered by a European guarantee, to replace a sizeable tranche of national debts?

Delors' Union Bonds

Nearly 20 years ago, in 1993, Jacques Delors proposed the issue of "Union bonds", whose repayment would be guaranteed by the Community budget, in addition to EIB (European Investment Bank) loans to finance infrastructure investments in transport, energy and telecommunications (*EC White Paper on Growth, competitiveness, and employment. The challenges and ways forward into the 21st century, (COM (93) 700 final*). This was a pale reflection of a much more ambitious and radical plan suggested to Delors by one of his economic advisers, Stuart Holland, who envisaged the issue of Union bonds by a European Investment Fund as a vehicle for the transfer of a substantial share of Member States' national debt to the Union. After such "tranche transfer" member states would continue to service their share of their debt, but at a lower interest rate (Stuart Holland, *The European Imperative: Economic and Social Cohesion in the 1990s. Foreword by Jacques Delors,* Nottingham: Spokesman Press, 1993). Stuart expected the bonds not to count as debt of the member states, by analogy with US Treasury bonds, but because member states would continue to service them that analogy does not hold. Neither did he contemplate any need for a Union guarantee: the EU having virtually no debt, Union bonds would be credible regardless. Union bonds remained a dead letter.

Eurobond redux

The recent euro crisis, correctly seen as a crisis of sovereign debt, resurrected the idea of a single Eurobond whose issue would gradually replace at least part of the member states' sovereign debt. In 2009-2010 several proposals in this sense were voiced again, among others by Paul de Grauwe and Wim Moesen (http://aei.pitt.edu/11091/01/1823%5B1%5D.pdf *Gains for All: A Proposal for a Common Euro Bond,* in: Intereconomics, Vol. 44, No. 3, 2009, pp.132-135), Daniel Gros and Stefano Micossi (*A bond-issuing EU stability fund could rescue Europe*, 2009, Europe's World, spring) http://www.europesworld.org/NewEnglish/Home/Article/tabid/191/ArticleType/articleview/ArticleID/21306/Default.aspx); Jacques Delpla and Jakob von Weizsäcker, *The Blue Bond Proposal*, (http://www.bruegel.org/pdf-download/?pdf=uploads/tx_btbbreugel/1005-PB-Blue_Bonds.pdf, Bruegel Policy Brief 2010/3, May); Erik Jones, (http://www.ispionline.it/it/documents/PB_180_2010.pdf *A Eurobond proposal to promote stability and liquidity while preventing moral hazard*, ISPI Policy Brief, n.180, March 2010); and, of course, Stuard Holland again (*Europe needs a Gestalt shift*, http://www.huffingtonpost.com/stuart-holland/post_1320_b_787643.html, 2010 and elsewhere).

One such scheme was authoritatively backed by Luxembourg Premier and Treasury Minister Jean-Claude Junker and the Italian Finance Minister Giulio Tremonti in the Financial Times of 5 December 2010 (http://www.ft.com/cms/s/0/540d41c2-009f-11e0-aa29-00144feab49a.html#axzz1DDL8Vy00 *E-bonds would end the crisis*). Giuliano Amato also forcefully endorsed it (in *IlSole-24Ore* of 11 December 2010). But German Chancellor Merkel and French President Sarkozy rejected the idea, together with the alternative proposal of raising the size of the EFSF (European Financial Stabilisation Facility) set up in May 2010 to deal with Euro-zone sovereign default .

Lower interest rate

The scheme for a single Eurobond comes in different sizes and forms, but all proposals have an underlying consideration in common: a European bond would attract a lower interest rate than the average (weighted) interest rate at which nation states could borrow in international markets, because of its higher liquidity and the lower credit risk. The funds raised through issues of a single Eurobond could be channeled to Eurozone member states in various ways: by buying their new national bond issues, or by buying back old national bonds, or by lending to member states against the security of domestic bonds. If a tranche of member states' debt could be "transferred" to the EU in this way, say something of the order of 60% of European GDP, in line with EU own-policy stated in the Maastricht Treaty and the Growth and Stability Pact, a Eurobond should not worry global financial markets. A stock of all-European bonds would give the Euro a wider appeal and promote its diffusion as a reserve currency. Eurozone debt as a percentage of GDP was 84% in 2010 (79% in 2009), 60% of it would be €5.5 trillion, large enough to compete with the US Treasury bonds and reap any conceivable benefits in terms of liquidity.

Responsibility for servicing these bonds could be envisaged as: several; several and collective; European.

Several responsibility

Every participating member state would be responsible for servicing these bonds in a pre-fixed proportion, say proportionally to the shares it holds in the European Central Bank (the kind of approach followed by De Grauwe and Moesen, 2009).

But an investor potentially interested in this type of bond could invest in it today, simply by purchasing a portfolio of bonds issued by all member states in the same proportions. Such composite instruments are not unusual: the Markit iTraxx SovX Western Europe Indez, for instance, is a basket of mostly Eurozone Credit Default Swaps. The yield on such composite bond would have to be exactly the same as that of a corresponding balanced portfolio of national bonds. There would be no interest saving in issuing such a bond, for it would be a useless exercise. If the bond attracted a liquidity premium so should the composite portfolio, and financial intermediaries would profit from its introduction on an increasingly larger scale and, therefore, they would be bound to introduce it, without any official initiative or inducement.

Collective and several responsibility

Under this kind of scheme the bond could be covered by a "collective and several" guarantee, i.e. in case of default bond-holders could claim reimbursement from any participating member state of their choice (cf for instance, Jones 2010). A spokesman for President Sarkozy was reported as saying. "This proposal is not entirely new. It raises difficulties notably in terms of sharing costs and profits... " (*Eurointelligence.com*, 10 December 2010). Obviously the interest cost of borrowing through a single Eurobond, though lower than the average cost of borrowing individually by member states, would be higher than that applicable to “virtuous” states. However the lower interest rate due to the lower risk and enhanced liquidity could benefit all: all countries could be charged a rate lower than but proportional to their own market rate, all being better off, even leaving something left over for accumulating a reserve.

In the case of several and collective responsibility for the bonds, however, there would remain two distributive problems. A minor problem is how to cope with member states with a debt/GDP ratio lower than the tranche of national debt whose transfer to the EU is envisaged. Slovakia at 42% debt/GDP ratio in 2010, Slovenia at 34%, Luxembourg at 20%, or Estonia with with a paultry 8%, would have to be granted a scaled down maximum liability in case of default. A second, major, problem is that more “virtuous” countries like Germany would be more exposed than weaker members to the risk of having to bail-out defaulters; who could indulge moreover in "moral hazard" behaviour and deliberately take advantage of the cover from such collective responsibility (though moral hazard would be limited to the share of their debt covered by Eurobonds, since the rest of their debt would attract a higher marginal interest rate). Thus it is perfectly understandable that Germans and other "virtuous" member states would be irreducibly opposed to such a scheme (unless accompanied by the realization of objectives close to the hearts of the virtuous, e.g. fiscal conformity across EU member states). True, even as things are now these countries are exposed to the risk of having to bailout defaulters, so much so that interest rates on German 10-year bonds have also increased from under 2% to almost 3%. But as things are now their liability is not automatic, it can be accepted or refused according to German perceived interests (such as German banks exposure to default), and subjected to conditionality imposed on defaulters. Therefore such a solution of collective and several responsibility for the single Eurobond is almost certainly politically impossible.

A European guarantee

Under this type of scheme the bond would be covered by a European guarantee extended by a hypothetical European Debt Agency that would have the task of "managing" a debt that has now become European. But "managing" debt involves manipulating the term structure of debt (funding and un-funding) and cover of exchange rate risk of bonds issued in foreign currency and the like, not the burden of debt service and repayment. *It is crucial to consider that the European Union budget represents just over 1% of European GDP and, what is devastatingly worse, has a ZERO primary surplus, because the EU lacks the power of taxation and its scant revenues (primarily a share of VAT and the shrinking revenue from external common tariffs) can be supplemented by national contributions proportional to GDP only to balance the books and no more.* Thus neither the EU Budget nor special Agencies obtaining resources from it can "manage" European debt, including its service, on the scale envisaged by the proposals (of the order of magnitude mentioned above, of over €5 trillion). Therefore such Eurobonds would get a rating lower than, say, that of Italy, who with tax revenues of 43% of GDP has at least the theoretical possibility of running a primary surplus and servicing its debt.

Under a European guarantee the bonds in question would be among the junkiest of junk bonds, with a credit rating and an interest spread not lower but higher than the Eurozone average.

Junk bonds, unless…

Unless the Agency in charge of debt service were to be endowed from the start with an amount of resources adequate to credibly guarantee its Eurobond issues. But:

The EFSF could not act in that capacity because it can count only on participant states' national guarantees, not ready cash. Thus bond issues have to be over-collateralised in order to secure AAA rating since they are guaranteed by less-than-AAA rated countries, reducing the EFSF operational capacity from the trumpeted €440bn to about 230-240bn. And such funds would partly dissolve with any downgrading of guarantor member states, and would vanish proportionally to their share in the case of their default. So much is this so that a proposal has been discussed in Brussels "in finance ministry circles" whereby non-triple A nations such as Italy, Spain and Belgium should contribute cash payments to the EFSF rather than guarantees (*Eurointelligence.com,* 21 January 2011). And recently Eurostat ruled that "Member states will have to account for EFSF's debt issues as gross debt, proportionate to their share in the EFSF" (*Eurointelligence.com* 28 January 2011).

Nor could the ECB act in the capacity of guarantor, for several reasons. First, even modest ECB purchases of the sovereign debt of the weaker states during the recent crisis (on a scale of just over $82bn since last February) raised concerns about the quantitative growth and above all the quality of ECB assets, which required a more than doubling of ECB capital from €5bn to €10.8bn at the end of 2010. Secondly, the ECB has announced last week that even those purchases have come to an end. Thirdly, such operations are bound to infringe ECB independence and the pursuit of its inflation target of close to 2% but no more than 2%. Alberto Quadrio Curzio (*Corriere della Sera*, 12 December 2010) has suggested the issue of €1000bn bonds guaranteed by the surplus gold holdings of Eurozone Central Banks; Germany's 3,406 tonnes, plus Italy's 2,451 tonnes and France's 2,435 tonnes, together these countries (representing 64% or Eurozone GDP) hold reserves higher than those of the Fed at 8,133 tonnes. This may not be the best course of action, for it would impinge on Central Banks independence and meet general legal obstacles (as well as special obstacles in a country like Italy where the Central Bank has the curious feature of still having dominant private shareholders); but at least Alberto has faced the issue squarely and suggested a possible solution.

Certainly the EIB could issue Eurobonds on a large scale – although if and only if its capital were raised to an extent commensurate with the scale of its envisaged operations, in the form of monies actually disbursed up-front or guaranteed by AAA-rating states and not, as Stuart Holland so implausibly argues, simply because it can finance national investments with loans that are alleged not to count as national debt (they still need to be serviced by borrowing member states, why should they not count as part of their debt and where in the treaties does it say that they do not?). The same could be said of a correspondingly capitalized European Debt Agency or similar *ad hoc* institution. But any such capital increase would have to be raised by the weaker (low rating, high spread) individual states first.

Would global financial markets really be sufficiently benevolent, enlightened and optimistic as to see such an increase in national debt as a move towards the reduction of European sovereign risk? Suppose the indebted individual members of a family incurred new debt to provide a family-guarantee on some of their debt; would creditors really regard this as offering them additional protection, or as an increased risk of default deriving from moral hazard encouraging higher profligacy by those family members?

Without a considerable and effective tightening up of fiscal constraints, as demanded by Germany, it is unlikely that Euro-zone creative accounting via the creation of a Special Debt Agency – a kind of Special Investment Vehicle à la Enron – would restore global investors' confidence in Euro sovereign debt. The single European bond seems to require fiscal Union as its pre-condition, rather than being a substitute for fiscal Union. Not in our lifetime (i.e., over our dead bodies) comes the Eurosceptic, nation-staters' cry.

Think Small: the solution

Fiscal Union is not a yes or no option: it comes piecemeal too, responding to the minimum stake that different member states can afford or stomach. All that is required is that at least some of the national tax revenue of member states – corresponding to a uniform, at least initially small percentage of national GDP – is specifically earmarked to servicing the single Eurobonds issued by a European institution. This is how it could begin; its effects would be cumulative over time. Of course it would not generate additional resources to service sovereign debt but, starting from the other end of the salami, so to speak, it would be an effective way of enforcing the fiscal constraints that are a precondition of both a European response to European sovereign debt and an ever-deeper Union. If not now, when?

And if not, is there European life after member-state sovereign default?