

OPEX MEMORANDUM No. 147/2010

AUTHOR: ERIK JONES, Professor of European Studies of the SAIS Bologna Centre of the John Hopkins University. He is also a collaborator of Opex.

TO: OPEX **DATE:** 21/07/2010

SUBJECT: A MARKET ALTERNATIVE TO FISCAL DISCIPLINE IN EUROPE; A PROPOSAL FOR A EUROBOND FACILITY

Panel: Economía Internacional

Coordinator: Manuel de la Rocha Vázquez

www.falternativas.org/opex

Depósito Legal: M-54881-2008

ISSN: 1989-2845



Director: Nicolás Sartorius

Subdirector: Vicente Palacio

Coordinadores de Área: Mario Esteban (Asia-Pacífico); Rafael Bustos (Magreb-Oriente Medio); Raquel Montes (Unión Europea); Manuel de la Rocha Vázquez (Economía Internacional y África Subsahariana); Vicente Palacio (Relaciones Transatlánticas); Paulina Correa (Seguridad y Defensa); Katty Cascante (Cooperación al desarrollo); Érika M. Rodríguez Pinzón (América Latina).

Why there is a need for a Eurobond Facility?

The ongoing reform of European macroeconomic governance is making great strides in improving both multilateral surveillance and fiscal policy coordination. The members of the Task Force headed by European Council President Herman Van Rompuy should be congratulated for the speed and diligence with which they are guiding this reform effort. Nevertheless, the proposal they are developing, based on enhancing the enforcement mechanisms, suffers from the same genetic weakness as the old Stability and Growth Pact and the excessive deficits procedure that underpins it. When faced with a crisis situation where a large and powerful country has to choose between obeying the rules or making politically unacceptable fiscal adjustment, it will always be cheaper and easier to break the rules. Similarly, EU member countries may easily ignore their European commitments when the calculation of costs and benefits for doing so points in that direction. That is why France and Germany suspended the excessive deficits procedure in 2003; that is why 24 of 27 European Union member states find themselves within the excessive deficits procedure today.

What the European Union needs is a system for fiscal discipline that can remain credible in times of crisis. This should be a system that allows countries to borrow in moments of extreme economic weakness, but that encourages them to do so in moderation, setting incentives for them to bring their debt back down to sustainable levels once the crisis has passed. Most important, it should be a system where the cost of defection is always higher than the cost of playing by the rules – not just for smaller countries that can be punished by their larger neighbours, but even for the most powerful of European Union member states, France and Germany included.

A powerful proposal that would address many of those problems would be the creation of a limited access common Eurobond Facility, through which member states would have limited borrowing rights.

Such a Facility has already been put forward by experts. Yet, drawing on the best arguments made in each of the proposals, this Memo seeks to make a strong case for the Spanish Government (which could be an important beneficiary) to advance it in official EU forums.

What would be the main features of the Eurobond Facility?

Eurobonds would have to be issued by a common authority and supported by the wider architecture of European macroeconomic governance. The precise institutional design is less important than the principles upon which such an authority would operate. The most important features of the proposed Eurobond Facility are the following:

- The bonds would be denominated in Euros and could be issued at different fixed maturities in line with the portfolio requirements for treasury operations.
- The bonds would be undifferentiated and no individual bond could be associated with a particular member state. The implication here is that every bond will be backed by every member state in a manner similar to the pro rata guarantees provided to the European financial mechanism that was created to fund the European Union's response to the sovereign debt crisis.
- Member States must commit to honour their common Eurobond obligations before any other credit liability.

- Member state access to bond issues would be limited as a share of their income. The most obvious ceiling would be the 60 percent debt-to-GDP per country threshold set in the Maastricht Treaty, however it would also be possible to introduce intermediate thresholds at lower levels with a graduating scale of charges associated with higher borrowing rates, up to the ceiling of 60 percent.

The characteristics described combine to form a very large, uniform, and low risk market capable of rivalling or even surpassing the market for United States Treasury paper in terms of depth and liquidity.

What would be the advantages for Member States that participate in the Eurobond Facility?

The principal advantages come from the price and stability and that such a Eurobond would offer.

- For most Member States, the Eurobond Facility would allow them to borrow funds at a lower cost than the current price they pay in the market;
- Eurobonds would be an attractive and safe investment for many non-European countries which would decide to diversify their foreign currency reserves, thus balancing the US as the only reserve currency in the world. In turn, this attractiveness would increase the depth and liquidity of the Eurobond market as compared with existing national bonds, further lowering the price of credit and increasing the incentives for Member States to participate;
- The benefits from the Eurobond are also linked to the stronger discipline it will impose on those countries participating in it, which would reduce the risk of defaulting, thus compromising the stability of the whole Eurozone;
- Ultimately, the issue of Eurobonds at the EU level would be an step forward in the path to closer European integration and a key pillar of the European economic governance.

How would a Eurobond Facility force Member States to maintain more fiscal discipline?

Eurobonds would create strong positive incentives for governments to borrow responsibly:

- Member States would have to qualify to participate, primarily by meeting rigorous standards for fiscal accounting and budgetary transparency just as firms accept when they list on a stock exchange;
- Member states would have to open their fiscal accounts to close scrutiny to qualify for new borrowing and again like firms belonging to a stock exchange, they would risk suspension of their borrowing privileges should they fail to maintain transparent accounts;
- The amount Member states could borrow would be strictly limited in proportion to their income and, like homeowners, they could face escalating premiums as they move close to their maximum borrowing threshold to cover the increasing risks that even higher levels of responsible borrowing entails;

- A Member States' participation could be suspended – in the sense of suspending the right to raise new money through the common Eurobonds until certain conditions are met – and it can also be revoked. If and when a country would be suspended all new issues will be blocked and the country's position within the facility will be wound up as existing bonds reach maturation.

In summary, participation by the Member States in the common Eurobonds would be both a commitment and a privilege. This combination creates both credible incentives and credible sanctions. Moreover, by varying the period of suspension from the facility, it is possible to graduate the sanctions very precisely to coincide with any problems as they occur.

What would be the implications of the Eurobond Facility for national bonds?

A common Eurobond Facility would also leave open the possibility for governments to borrow in extremis. Once their right of issue is exhausted, governments can always use national bonds instead of common Eurobonds to raise funds on the market. However, these national bonds will be considerably more expensive to issue than common Eurobonds because:

- National bonds will have a weaker claim to repayment – member states will have to commit to service common Eurobonds first;
- National bonds will come in smaller issues with thinner markets – the common Eurobonds will be issued in relatively large volumes by every member state, the national bonds will be issued in small volumes and will differ from one member state to the next;
- National bonds will have less institutional support to maintain liquid markets – the European Central Bank (ECB) will obviously accept common Eurobonds as collateral in central banking operations, but it will not be constrained to accept national bonds unless they meet fixed rating criteria.

At the same time, national bonds would be subject to greater market discipline and will be more expensive than common bonds as a source of funding. This is much like credit card debt when compared to mortgage debt – the governments that issue them will face a powerful incentive to pay them off and so bring their net borrowing back down to responsible levels. Two additional implications should be mentioned as well:

- First, national bonds would carry a visibly higher risk of default in terms of payment moratoria, haircuts, term extensions, etc. and so investors in these bonds will have an incentive to know the risks they are undertaking;
- Second, countries would be able to default on their national bonds without raising the risk of default across their whole debt profile, which implies that the collateral damage to the banking system of a national fiscal crisis will be less extensive.

Hence, national bonds would become an important source of information about when a member state's debt is becoming too big without at the same time resulting in that member state becoming 'too big to fail'.

Which countries would be allowed to join the Eurobond Facility?

Participation in the Eurobond Facility should be voluntary and membership should be open to any Member State that is willing and able to meet the reporting requirements and to accept the repayment obligations.

Voluntary participation is important for two reasons:

- First, some member states may only be able to join on the basis of constitutional amendment and popular referendum. In those countries, political leaders will have to make the case membership and choose an appropriate time for joining. As the experience of Sweden and the eurozone has demonstrated, legal obligations do not improve the prospects of membership. On the contrary, legal requirements may force the pace of decision-making and instead result in curious legal anomalies (like Sweden's non-participation in the eurozone) and popular distrust and resentment;
- Second, voluntary commitments are stronger commitments because they ensure that the debate about participation is grounded in national self-interest and because they offer greater transparency and accountability at the national level.

Making membership open to non-eurozone Member States follows established precedent for institutional arrangements designed to support the function of the euro; the Trans-European Automated Real-time Gross settlement Express Transfer system (TARGET and now TARGET2) allows non-eurozone member states to join as well. As in TARGET, the principal distinction is that non-eurozone member state have to accept any exchange rate risk and settlement requirements attached to working in euros. Moreover, the advantages of allowing non-eurozone Member States to join are considerable.

- Participation in the Eurobond Facility would strengthen incentives for non-eurozone countries to improve their fiscal accounting and consolidate their budgetary positions;
- It would allow governments to benefit from a lower cost of financing for responsible borrowing without spreading the low interest rate structure across the society as a whole in an inappropriate or pro-cyclical manner (as happened in Latvia);
- It would help non-eurozone member states better manage or restrict their foreign currency debt exposure (as in Hungary).
- Finally, non-eurozone participation in a Eurobond Facility would reinforce the process of convergence on eurozone membership by creating an intermediate institutional step from which the advantages of full membership are stronger because only adoption of the euro can eliminate any remaining exchange rate risk.

Voluntary and open participation in a Eurobond Facility would not only stabilize the functioning of the eurozone; it would strengthen the process of monetary integration as a whole.

What would be the implications for Member States of leaving, or being suspended, from the Eurobond Facility?

Member states could be suspended or kicked-out of the Eurobond Facility, thus losing the benefits they obtain from it. Yet, it will always be cheaper to stay in the Eurobond Facility than to break the rules, even for the largest and most powerful member states. The logic here is not unlike the arguments used to explain why countries do not exit the Eurozone.

- The transition costs for moving from treasury operations based on common Eurobonds to national bonds, both within the government and across the banking system would be significant;
- The country's borrowing costs after the transition would be considerably higher; and,
- The symbolic implications both for the individual member state and for the European integration project as a whole would be both obvious and negative.

In other words, defecting from the system would always be more expensive than complying with the obligations of membership. The discipline of the system would be much more credible as a result.

What are the principal objections to a Eurobond Facility and from whom?

Apart from some experts, high profile political figures like Belgian Prime Minister Yves Leterme and European Council President Herman Van Rompuy have made similar proposals as well. Each time, however, they have encountered an immovable obstacle in German Chancellor Angela Merkel and her government. The argument the Germans make is two-fold:

- First, such a Eurobond would violate the no-bailout principle according to which neither member states, nor European institutions may assume responsibility for one-another's debts;
- Second, such a proposal would raise borrowing costs for Germany, which is already the first contributor to EU expenses, and there is no willingness on the part of the German people to shoulder this additional burden.

The first argument is more concerned with legality than principle. If the principle behind the no bailout clause is to prevent moral hazard in the conduct of government finances, then this proposal meets that goal better than the original Treaty language. None of the Treaty provisions succeeded in preventing Greece from reaching an unsustainable financial situation and none of them prevented the other European Union Member States from coming to Greece's assistance.

The second argument about relative costs is more difficult to dismiss, particularly when German government debt is trading at a significant premium (high price, low yield) to most other member states. Nevertheless, it is important to remember the context. German government debt is expensive in the market and so cheap for the German government because Europe is in an economic crisis. During the pre-crisis period after the start of the single currency, the difference across countries was much less significant. In that pre-crisis setting, the much deeper markets available to a common Eurobond would actually work to Germany's benefit.

Germany would benefit from lower interest rates during periods of crisis as well. The comparison across countries misses an essential component. At the moment, the prices attached to national bonds reflect the entire volume of each country's debt. With a common Eurobond, the only responsible share of borrowing will be reflected in Eurobond prices and the excessive borrowing will be reflected in national bond markets. So long as Germany continues to borrow responsibly, its financing needs will be met by Eurobonds that will be as much a safe haven in the future as German bunds are today. Germany will continue to benefit from favourable financing rates even as the rest of Europe will see the incentives for fiscal discipline enhanced.

Memorandos Opex de reciente publicación

- 146/2010. **Elecciones presidenciales en Colombia: el triunfo de Juan Manuel Santos, una política de continuidad frente una oportunidad para el cambio.** Érika M. Rodríguez Pinzón
- 145/2010. **Consideraciones preliminares acerca de la reciente VI Cumbre ALC-UE.** Facundo Nejamkis
- 144/2010. **La Cumbre del G20 de Toronto ante la crisis económica internacional, propuestas para la UE.** Manuel De la Rocha Vázquez y Domenec Ruiz Devesa.
- 143/2010. **¿Cómo se financian y cuánto le cuestan a España las misiones internacionales de paz?** Paulina Correa.
- 142/2010. **Philippine elections 2010: definitely not more of the same, but can the same be said of the next administration?** Herman Joseph S. Kraft.
- 141/2010. **El mecanismo Europeo de estabilización: ¿hacia un fondo monetario europeo?** Domènec Ruiz Devesa.
- 140/2010. **Equidad de género. Un objetivo prioritario del Gobierno español en la Presidencia de la Unión Europea.** Ana Lydia Fernández-Layos.
- 139/2010. **La crisis del Euro.** Santiago Fernández de Lis y Emilio Ontiveros.
- 138/2010. **La cooperación con América Latina: hacia una estrategia europea comprometida con la calidad.** Anna Ayuso y Christian Freres
- 137/2010. **2ª Cumbre UE-Pakistán: el reto de la relevancia europea.** Rubén Campos Palarea
- 136/2010. **Mejorar la gobernanza económica de la zona euro con dos piezas: el procedimiento de rescate y la coordinación económica.** Clara Crespo.
- 135/2010. **El Estatuto avanzado UE-Marruecos y la Presidencia española de la UE.** Irene Fernández-Molina y Rafael Bustos.
- 134/2010. **Posición española para el Acuerdo de Asociación Centroamérica - Unión Europea.** Ángeles Sánchez y Kattya Cascante
- 133/2010. **Ucrania tras la elección de Yanukovich: entre la UE y Rusia.** Javier Morales Hernández y Rubén Ruiz Ramas
- 132/2009. **La Presidencia española de la Unión Europea y la Agenda Transatlántica.** Vicente Palacio, Ángel Pascual Ramsay y Charles Powell
- 131/2009. **Continuidad en Mozambique: tendencias y expectativas.** Marcos Suárez Sipmann
- 130/2009. **La agenda hacia Asia y el Pacífico de la Presidencia Española de la UE.** Mario Esteban, Gracia Abad, Rubén Campos, Alfredo Crespo, Javier Gil, Ana María Goy, Nicolás de Pedro, Eunsook Yang
- 129/2009. **Yukio Hatoyama: ¿Una nueva política exterior para Japón?** Mario Esteban Rodríguez
- 128/2009. **Aportaciones a la política de desarrollo europea desde la Presidencia española.** Veronique Andrieux Araujo
- 127/2009. **Cambio climático: perspectivas y prioridades de España en política de cooperación al desarrollo.** Jesús Quintana
- 126/2009. **Recomendaciones para una mayor presencia del Comercio Justo en España.** Rodrigo Fernández Miranda.
- 125/2009. **The Eastern Partnership and the regional dynamics within the EU; What consequences for Spain?** Álvaro García Navarro.

Para consultar los memorandos anteriores en pdf, pueden visitar nuestra página web <http://www.falternativas.org/opex>