The “eurobond” proposal: A challenging path towards integration

Discussions over the creation of a eurobond date back prior to the creation of the single currency itself. No matter how strong political opposition may be, as long as cross-border capital markets are still inefficient at assessing sovereign risk and averting moral hazard, eurobonds will be necessary and the debate will persist.

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Abstract: Despite being a recurrent theme in discussions over euro area reform, the eurobond proposal seems to be gaining little traction as regards its conversion into actual policy. Various concepts of the eurobond date back prior to even the creation of the euro itself. The most recent proposals for a mutualized sovereign debt instrument contain both advantages and risks. On the positive side, such an instrument would provide increased legal clarity in the event of a restructuring, as well as create a large class of relatively risk-free assets. However, risks related to legal certainty, political control, financial liability and finally, moral hazard make it politically difficult to sell to an already sceptical public.

In this context, the European alternative is to push for greater national responsibility and to support that with limited forms of conditional lending. The question is whether or not such an alternative will be sufficient. Cross-border capital markets are still inefficient at assessing sovereign risk and averting moral hazard – particularly, but not exclusively, in a common currency area – and cross-border capital flight has such destructive consequences for European economic performance. Thus, eurobonds will be necessary and the debate over their creation will remain present.

Introduction

Four days before European Commission President Jean Claude Juncker gave his "State of the Union" address to the European Parliament on September 13th, 2017, Claudi Pérez (2017) published a story in *El País* claiming that the speech would propose the creation of "eurobonds" by 2025. If it had been made, the proposal would have been surprising – several countries have voiced their concern to joint-and-several credit commitments. Nevertheless, the European Commission seems determined to bring the proposal forward. As one Commission official explained to Pérez: "Eurobonds are a fantasy, but the EU (European Union) and the euro were also" (Pérez, 2017).

The eurobond proposal did not make it into Juncker's speech upon delivery [1]. Instead, he called for the completion of the European banking union through the reduction of risks within Member States before building out mechanisms to share risks across them; he proposed the transformation of the European Stability Mechanism into a European Monetary Fund; he recommended that the European Commissioner for Economic and Monetary Affairs be elevated to European Economics and Finance Minister and Eurogroup President with real powers to promote structural reform at the Member State level; he suggested that this new Economics and Finance Minister have access to a euro-area budget line within the Commission's financial framework; and, he insisted that every EU Member State accept its obligation to join the euro.

Despite its omission, however, it would be a mistake to discount the idea of eurobonds altogether. In their joint "letter of intent", Commission President Juncker and his Vice President Frans Timmermans listed "exploratory work for the possible development of a euro area safe asset" among the initiatives to be launched looking ahead to 2025 [2]. That proposal echoes the European Commission's (2017) reflection paper on economic governance, which suggests that a 'European safe asset' is one of the instruments that could be developed after 2019. The purpose of this article is to explain why the eurobond proposal is such a recurrent theme in discussions about reforming the euro area and why that proposal seems to gain so little traction in the development of actual policy. Eurobonds offer a number of advantages in terms of market access, project finance, market discipline, and financial stability. The problem is that financial economists have not been able to design an instrument that captures these advantages without creating risks related to legal certainty, political control, moral hazard, and financial liability. Worse, each effort to increase the sophistication of the proposal has only given rise to greater fears about potential unintended consequences.

Such fears are perhaps more important for the politics of eurobonds than for their financial engineering. It is possible to imagine a proposal that maximizes advantages while minimizing risks; it is more difficult to see how to sell that proposal to an already skeptical public. Proponents of eurobonds will not

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abandon the pursuit of the advantages that such instruments have to offer; they just have to find a political route to get there. Moreover, this dilemma is not limited to Europe. Despite the unique history of European financial and monetary integration, every country – and particularly every large federation – has faced similar dilemmas in building a framework for financial stability.

The advantages of eurobonds

The term “eurobond” has been used for much longer than Europeans have shared a single currency. The concept dates back to the creation of “offshore” financial markets in Europe to recycle excess liquidity created outside national financial regulatory environments or capital controls by countries running export-led growth models. Over the years, the same term has been used to describe a range of different instruments for the joint financing of infrastructure investments, sovereign debt mutualization, and the creation of a risk-free asset for use as collateral and safe haven (Table 1). Hence the temptation whenever the term “eurobond” arises is to try and focus on the specific incarnation and to cut away those that do not apply. For example, when Wolfgang Munchau reported on the *El País* article mentioned at the start of this essay in his euro *Eurointelligence blog*, the first point he made was: “it’s not clear whether these are true eurobonds from a common debt-issuing capacity or the synthetic halfway-house of sovereign bond-backed securities (SBBS or ESBies for European Safe Bonds in earlier incarnations of the idea)” [3]. In fact, the “letter of intent” lists both projects separately.

The evolution of the term “eurobond” nevertheless helps to underscore the advantages that the whole class of instruments has to offer. Consider the original “eurobond”. That was an early expression of financial market integration at a time when national capital markets were strictly segregated. The idea was to tap a wider pool of savings than would be available in a given national currency. It was also to tap a group of investors who were capable of managing more sophisticated instruments. For firms from small countries, the eurobond market played an important role in leveling the playing field by bringing their cost of capital closer to their large-country competitors. Prior to the introduction of the euro as a common currency, eurobond markets provided small-country governments with access to more competitive financing costs as well (Choudhry, 2010).

A more recent version of the eurobond focused not only on accessing wider European capital markets but also on solving the collective action problems associated with large, trans-

Table 1 **The four faces of the “eurobond”**

Eurobonds as:	Issued in:	Denominated in:	Issued by:	Underwritten by:
Access to foreign capital	“Offshore” markets	Foreign currency	Corporates or sovereigns	Individual issuers
Source of project finance	“Offshore” or on-shore markets	Euros	International organizations like the EIB	International organizations with paid-in capital from Member States
Mutualized sovereign borrowing	On-shore markets	Euros	Sovereigns with authorization	Joint-and-several commitment
Synthetic assets	Securitization markets	Euros	Financial firms	Tranche structure

Source: Author’s own elaboration.

European infrastructural investments. Such large projects create positive externalities for countries far from the specific works involved. It stands to reason, therefore, that other countries would be involved in the financing – and also in the risks that the projects might run over budget or even fail. The European Investment Bank and the European Bank for Reconstruction and Development can help to solve those collective action problems as well. The difference with using a eurobond has to do with leverage and, again, relative cost of capital. A single instrument backed by the joint taxing power of the EU Member State governments would make it easier to borrow counter-cyclically and so use large-scale investment projects for macroeconomic stimulus in addition to infrastructural improvements (De Grauwe and Moesen, 2009). It would also make it easier for European governments to recapitalize banks in distress that have large assets portfolios and substantial cross-border exposure (Gros and Micossi, 2008).

But the current tensions surrounding the eurobond debate are not centered around the eurobonds used by corporates or sovereigns in offshore markets or by international organizations to finance cross-national infrastructure investments, as these do not pose a major problem, in principle. Two other eurobond proposals – one to mutualize existing sovereign debt and another to securitize sovereign debt in order to create a European "safe asset", however, are distinct, because they go to the core of the management of the euro area economy. The newer versions of the "eurobond" raise complex issues of moral hazard and financial stability.

Hence, for example, the notion of cost-of-capital can cut both ways. Firms or governments that have access to competitive financing costs will take great pains to ensure they do not lose those benefits. This insight lies behind a different eurobond proposal that offers governments only limited access to credit markets through the issuance of mutualized sovereign debt instruments with the implication being that governments will lose privileged access once their borrowing limit is exhausted. The notion here is no different from any other line of credit extended to firms or individuals – for whom borrowing within limits is less expensive than borrowing beyond them. Hence, the idea is to create a clear threshold beyond which the forces of market discipline would apply (Jones, 2010; Delpla and von Weizsäcker, 2010).

Restricting government access to mutualized sovereign debt instruments has two added advantages. To begin with, it signals to investors which debt is likely to be restructured in the event that a sovereign borrower finds itself in distress. Any borrowing beyond the limits would be junior in the market to borrowing through mutualized sovereign debt instruments. The other advantage is that the proposal creates a large asset class of instruments that have very little default risk because of the joint-and-several sovereign guarantees attached. Such instruments could be used for routine treasury operations in banks and large corporations, they could be the mainstay for collateralizing liquidity access with central counterparties and central banks, and they could provide a safe haven in the event of a large-scale flight to quality because of turbulence or uncertainty in financial markets.

This flight to quality is critically important in the context of the European financial crisis. It explains why capital was so quick to leave the countries on the euro area periphery and it also explains why the United States was seemingly more resilient. In the U.S., investors could all move their money into instruments backed by the U.S. Treasury; in Europe, they had to move their capital from one country to the next (Jones, 2016). Such cross-border capital flight played an important role in the Spanish crisis, for example, by not only pushing up the costs of government borrowing but also tightening the links between sovereign finances and bank recapitalization (Royo, 2013).

A mutualized sovereign debt instrument is not the only means for creating a large class of relatively risk-free assets. Another technique would be to rely on securitization to build synthetic assets backed by pools of sovereign debt instruments from different countries. This technique would avoid the challenge of creating a joint-and-several guarantee for repayment. It would also make it possible to assign responsibility for creating the assets to financial services providers in the private sector rather than relying on international organizations or agencies (Brunnermeier *et al.,* 2016). Finally, the synthetic “European Safe Bond” would retain many of the advantages of the different kinds of eurobonds that preceded it by tapping the wider pool of capital available in Europe, lowering relative borrowing costs. Such an asset could reduce the risk of moral hazard that could potentially arise in the case of the mutualized sovereign debt instrument, which looks more like a government guarantee. It would also make it easier to finance infrastructure investments and, when necessary, allow for macroeconomic stimulus and bank recapitalizations (where permitted), and bring more clarity to the market about which instruments are subject to default risk. These benefits could be reaped by all euroarea countries alike, even those currently in opposition to the proposal. Unfortunately, this is not sufficiently highlighted by European debates.

The disadvantages of eurobonds

The disadvantages of eurobonds flow from the various incarnations of the idea as easily as do the advantages. The perils of borrowing in offshore markets are a good place to start. Such markets not only give borrowers access to credit beyond their capacity for repayment, but also lock them into international currencies and legal frameworks that they cannot completely control. These disadvantages were obvious in the latter half of the 20th Century because recourse to international capital markets was more the exception than the norm. Borrowers realized the risks they ran even if they chose to ignore them as the price for obtaining access to a larger pool of available credit (Strange, 1986). In that sense, the link between the creation of eurobonds and the rise in moral hazard was manifest.

The situation became more complicated with the introduction of the euro. The existence of a currency that is both domestic and foreign was harder to understand and the implications that dual-nature has for borrowing internationally were harder to anticipate on both sides of the credit relationship. Hence it was possible for mainstream economists to imagine that even tightly compressed yield spreads on euro-denominated sovereign debt instruments constituted fair remuneration for investors facing different liquidity and default risks from one sovereign borrower to the next (Codogno *et al.,* 2003). With the benefit of hindsight, that interpretation of yield spreads is harder to accept. Moreover, economists have gained a new appreciation for the fact that national monetary authorities cannot ensure the solvency of government borrowing by printing additional currency any more than national governments can restructure the terms of repayment for contracts written abroad. Governments participating in the euro area could repay their foreign-currency denominated debt and yet still not achieve the autonomy typically associated with domestic borrowing. Moral hazard remained present only this time it was not as manifest [4].

The proposal to underpin sovereign borrowing with a joint-and-several guarantee across member states brought the problem of moral hazard back to the surface – particularly in the context of an economic crisis and particularly when framed as a vehicle to facilitate deficit spending and bank bailouts. Market participants may be forgiven for having underpriced the risk of default during the early years of the euro, and yet national politicians could not ignore the possibility that some of their number might not be counted upon to repay their debts once those default risks became apparent. Hence when the European Commission (2011) raised the prospect of joint-and-several guarantee in its Green Paper on European stability bonds, critics immediately denounced it as an ex ante transfer of creditworthiness from those more likely to repay to those less likely or able, and an ex post transfer of resources once the failure of some participants to live up to their obligations took place (Matthijs and McNamara, 2015).

Here the early experience of eurobonds as a form of capital market liberalization is again important. As Susan Strange argued

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in the mid-1980s, the creation of "offshore" markets shifted much of the risk associated with international lending from creditors onto debtors (Strange, 1986). This created a moral hazard insofar as debtors ignored those risks. Any situation that shifted the risk back onto creditors while giving debtors the same market access would be worse because it would create an incentive for debtors to take advantage of new forms of creditor weakness.

The same problem of moral hazard emerges wherever EU Member States have a joint-and-several financial commitment (Newman, 2015). The European Financial Stability Facility and its successor European Stability Mechanism (ESM) are one illustration; the balance sheet of the European Central Bank (ECB) together with its network of corresponding institutions are another. Hence, political opposition to eurobonds is not unique; it extends to the use of ESM resources for the direct recapitalization of financial institutions in distress, to the direct purchase of market securities by the ECB, and to the provision of emergency liquidity assistance by national central banks. But this opposition is not universal and neither is it unyielding. While some countries which face little or no risk premium on their borrowing costs like Germany or the Netherlands oppose the idea, other countries that face higher risk premiums like Spain and Italy continue to support it. Nevertheless, for the moment at least, the opposition to eurobonds persists – not just with respect to eurobonds per se but also with respect to any other joint-and-several credit commitment. Thus, it is important to view the debate over the eurobond proposal within a wider political context.

Without that wider context, it would be difficult to understand why there is such strong opposition to creating a eurobond with restricted access as a means of ensuring Member State governments face market discipline when they engage in excessive borrowing – defined as borrowing beyond the limits of the joint-and-several commitment. Such a proposal would seem to address the problem of moral hazard by placing strict limits on mutualized borrowing. Nevertheless, for politicians concerned about moral hazard, the existence of limits for accessing mutualized sovereign debt obligations is no more reassuring than the restrictions on ECB asset purchases or emergency liquidity assistance. By the same token, the promise to repay mutualized sovereign debt obligations or to treat them as senior in the market is no more credible than the commitment to honor the direct recapitalization of private banks with European resources. Such instruments should be available in extremis, so the argument runs, and yet they should not be part of routine European public finances lest they give rise to new forms of financial dependence and (potential) intergovernmental conflict. For skeptics of the joint-and-several commitment, the sequential showdowns between the ECB and Ireland, Cyprus, and Greece over the provision of emergency liquidity show just how quickly such conflicts can escalate (Jones, 2013 and 2015a).

Without some kind of mutualized sovereign debt instrument, however, it is challenging to see how Europe's heads of state or government can create a common pool of risk-free assets that would be large enough and liquid enough to provide for routine treasury and liquidity operations and to act as a safe haven during periods of market turmoil. The securitization of existing sovereign debt instruments goes some way in avoiding the problem of making a joint-and-several commitment (Brunnermeier *et al.*, 2017); nevertheless sovereign debt securitization threatens to create a number of other distortions across national sovereign debt markets and in the balance sheets of peripheral country banks that render the proposal ineffective if not counter-productive (Minenna, 2017). Moreover, without a common risk free asset, European financial markets remain vulnerable to the kind of sudden-stop dynamics that result from cross-border capital flight. These are problems more commonly associated with developing countries that access “offshore” markets than with advanced industrial economies. Finally, while the ECB asset purchase programme may have helped attenuate the risks associated with the lack of a European safe asset, the positive impact of the ECB remains limited and cannot be maintained indefinitely. Thus, given the structure of European financial integration both inside and outside the euro area, however, the problem of “sudden stops” is now relevant to Europeans as well (Jones, 2015c).

Technology, politics, and the European alternative

The “eurobonds” we talk about today as a form of common risk-free asset and potential mechanism for promoting market discipline within the euro area continue to resurface in debates about euro area reform because of the implications of the “eurobonds” we talked about in the latter 20th Century as a means of facilitating the movement of capital across borders. Put another way, eurobonds are necessary because cross-border capital markets are still inefficient at assessing sovereign risk and averting moral hazard – particularly, but not exclusively, in a common currency area – and because cross-border capital flight has such destructive consequences for European economic performance (Jones, 2015b).

In technical terms, the creation of a framework for “eurobonds” which give Member State governments limited access to borrowing with a joint-and-several underpinning would make European financial market integration more stable and hence also more beneficial. Such eurobonds would permit national governments to tap deeper capital markets, they would make it easier to internalize the externalities associated with transnational investment projects, they would facilitate counter-cyclical fiscal spending, they would sever the link between sovereign finances and bank bailouts, they would make a clear distinction between responsible government borrowing and excessive public indebtedness (which may be subject to restructuring), and they would provide a deep and liquid pool of assets to ensure the liquidity of the financial system and to provide a safe haven for capital. Eurobonds are not the only way to create a common risk-free asset in Europe. However, short of the creation of a centralized European government with its own powers to borrow and tax, some form of mutualized sovereign debt instrument is the easiest way to create a large enough risk-free asset class to meet the functional requirements for Europe’s integrated financial market. Therefore, if the Commission is serious about exploring the possibility of creating a European safe asset, it is sure to look at debt mutualization.

In political terms, however, any form of joint-and-several commitment within the European Union – including mutualized sovereign debt obligations – creates possibilities for abuse that foster distrust among the member state governments and their electorates. By implication, eurobonds may be necessary and yet that does not mean they will be created. Moreover, there is no obvious technical solution to this lack of trust. The securitization of existing sovereign debt instruments achieves some objectives by side-stepping the joint-and-several underwriting and yet fails to address the deeper structural flaws in the model for European financial market integration.

The European alternative is to push for greater national responsibility and to support that with limited forms of conditional lending. These are the elements that were delivered

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in Juncker's 2017 state of the union address. They can be found in the phrases he uses to emphasize the importance of "(reducing) the remaining risks in the banking systems of some of our Member States" alongside the premise that "risk-reduction and risk-sharing go hand in hand". The proposal to transform the ESM into a European Monetary Fund and to create a European Minister of Economy and Finance falls into this area as well [5]. The implicit promise that Europe's banking union will one day include a fully-funded European Deposit Insurance Scheme if the Member States do their homework first seems to go beyond this limited vision of the European alternative. Nevertheless, it is as easy to find opposition to a common European deposit insurance scheme as it is to find opposition to any other joint-and-several commitment (Brundsen, 2015). The European alternative consistently veers away from the threat of moral hazard in that respect.

The question is whether the European alternative will be sufficient to contain the dynamics unleashed within an integrated financial marketplace. The answer is not likely to be found in Europe – at least not yet. Instead it can be found in other countries.

Financial market integration used to take place within countries rather than between them, as national governments sought to liberate the capital that was trapped in sub-national jurisdictions. In those national cases, the balance between technological advancement and political reticence was often much the same. National governments can easily imagine how to structure collective borrowing arrangements but they have little desire to bail out "irresponsible" cities, provinces or regions. Sometimes in their search for an appropriate balance they have arrived at an institutional equilibrium much like the European alternative proposed today, where subnational governments retain responsibility for their own finances and financial institutions. Often those national equilibria proved precarious – and a powerful economic shock was sufficient to force the pace of technological change in favor of increasing joint-and-several commitments. The origins of the U.S. Federal Reserve System come from such dynamics; so does the system for federal deposit insurance. The evolution of joint-and-several financial institutions in the United Kingdom and Canada was similar even if the timing was different (Jones and Underhill, 2014).

The implication of this history is that eurobonds as a form of mutualized sovereign debt obligation are unlikely to disappear from the policy debate, even though they may be unpopular at the moment. So long as European financial market integration continues to suffer from the potential for cross-border capital flight and sudden-stop dynamics, the debate about eurobonds is going to remain present no matter how strong the opposition may be.

Notes

[1] The Commission's official website for the speech is here: https://ec.europa.eu/commission/state-union-2017_en

[2] The letter of intent can be found here: https://ec.europa.eu/commission/sites/beta-political/files/letter-of-intent-2017_en.pdf

[3] *The Eurointelligence blog* can be found at www.eurointelligence.com

[4] Paul De Grauwe (2016: 228-232) argues that the moral hazard was reduced as governments internalized the danger associated with a harder budget constraint. That is a plausible speculation and yet it does not vitiate the larger problematic.

[5] Quoting from the English-language translation of the speech. In the text as delivered, these passages were in German.

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