Safe Eurobonds as an attractive, liquid investment opportunity

Prof. Dr. Gerhard Illing, LMU University of Munich

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For more than 10 years, the Euro project - one common currency for many participating countries- performed impressively and seemed to turn into a fantastic success story. The Euro has been created as a "depoliticised currency" – its stability entrusted to an independent central bank with a clear mandate to maintain price stability, based on rules enshrined in international treaties. During the first 10 years, the European Central Bank achieved higher price stability than the Deutsche Bundesbank during the years of the German Mark. But right now, the Euro area is facing severe challenges. Some periphery countries seem to be on the verge of collapse, in the absence of support from the core. Voters and politicians in the core countries are reluctant to provide support, fearing a dangerous slippery route into a transfer union. The current crisis is a result of lack of adequate political governance structure. The way to address it is not an economic, but a political challenge.

When the Euro was created with one central bank being assigned to implement a uniform monetary policy across many sovereign countries, this was a unique experiment worldwide. Quite a few economists have been sceptical right from the beginning that a centralised monetary policy could work without a centralised fiscal counterpart. It was evident that the ECB might run into troubles when forced to act as lender of last resort without a central fiscal agency backing the fiscal risks involved. But at that time, many denied the need to coordinate fiscal policies. They argued that bond markets would do the job as vigilantes–punishing excessive spending of highly indebted countries by charging higher interest rates.

For good reasons, the founders of the Euro did not trust naively into the power of capital markets as disciplinary device. Instead, they opted to design the Euro with a minimal version of fiscal coordination, relying on a no-bailout clause and on weak limits for debt and deficit ratios in the Maastricht treaty. The hope that this minimal solution could work turned out to be an illusion. Since the start of the Euro 1999 until the breakout of the financial crisis in mid 2008, bond spreads across all participating countries converged steadily towards close to zero. Since mid 2008, in a dramatic reverse, spreads shoot up to alarming levels, triggered by doubts about the determination to solve the debt crisis.

Those trusting in the disciplinary force of rational markets see the recent spikes as evidence of serious solvency problems. They argue that bond spreads had been artificially compressed for a long time because markets initially did not trust the no-bailout clause in the Maastricht treaty. But calculating the political risks is a central part of the job of capital markets. Exactly for that reason bond markets are unreliable vigilantes of governments. They are prone to under- and overshooting in a world characterised by multiple equilibria, amplifying rather than correcting political failure. Doubts about solvency risk can easily trigger self fulfilling vicious spiral, turning a pure liquidity crisis into a solvency crisis.

A plausible reason of the compression of spreads before 2008 is that at that time, bond markets were betting on convergence across Europe, trusting in sound political governance of the Euro-area. Relying on the determination of European political authorities to turn the Euro area into a political union with well functioning institutions, they were willing to lend not just to the core, but also to formerly weak periphery members of this club. For the same reason, they were also willing to lend to Central and Eastern European economies, compressing their spreads as well. These bets were made in the hope that sound reforms in European governance structure will make them a profitable investment, resulting in a virtuous upward circle. But the financial crisis raised serious doubts about the willingness to continue along this route. Not surprisingly, with increasing distrust in political governance, bond markets turned their positive bet abruptly in reverse, triggering a vicious downward spiral, threatening a sudden stop of capital flows with unforeseeable contagion effects around the world. Doubts about the soundness of local banks amplified by the risk of being kicked-out of the Euro-area led private depositors to withdraw funds from banks in periphery countries.

At least up to now, ample provision of liquidity by the European Central Bank within the Euro-System helped to prevent a collapse of the financial sector. For obvious reasons, this support involves implicit fiscal risks – risks which ultimately have to be borne by the tax payer. The role of the ECB as lender of last resort uncovers a serious deficiency in the design of the Euro-area institutions: Normally, the risks involved have to be covered by the treasury as the democratically legitimised sovereign. In the UK, for instance, any potential losses incurred from Bank of England's quantitative easing program are indemnified by Her Majesty's Treasury. But in the Euro area, there exists no equivalent fiscal counterpart for the central bank. The ECB as the only effective institution able to take action in Europe is by construction a "depoliticised," independent institution, so it is not really legitimised to take over these risks. For that reason, the Governing Council of the ECB repeatedly stressed the responsibilities of the governments and pressed hard both to expand the rescue fund, the European Financial Stability Facility (EFSF) and to install a European Stability Mechanism (ESM). But the current governance

structure within the Euro area forces to act in slow motion – it requires unanimous approval by all individual countries involved. Without significant change, political actions in Europe are bound to stay "behind the curve."

The current crisis in Europe impressively reveals the weakness of political governance in the European Union. It demonstrates that a common currency cannot work properly without a central fiscal counterpart being able both to enforce required changes in taxation and spending across all nations involved and to take the responsibility for fiscal risks involved in lender of last resort operations. There is a straightforward remedy to address this weakness: In order to turn the Euro into a success, the next step towards a true "United States of Europe" has to be taken, installing a single "Treasury" to oversee tax and spending across all participating nations. Obviously, this requires some transfer of sovereignty from the nations to the European level.

In the medium run, there are just two realistic options: either a move back towards national currencies with policy being dominated by national interests or a brave step towards true European integration. The first route would mean an end of European influence in the global economy. It took a long way until the political leaders in the Euro area recognised what is at stake. But finally, they seem to move in the right direction, pushing for decisive steps towards a "United States of Europe." This way, the key flaw in the initial design of the Euro-area would be removed, paving the way for a broad and liquid market for common Euro-Bonds. Properly designed within an incentive compatible governance structure, they are the most promising way to cope with current challenges. Providing an attractive, liquid investment opportunity, they would help to restore growth opportunities both in Europe and worldwide.

This process, however, will take time. In the short run, unconventional measures have to be taken to restore financial stability without giving the wrong long term incentives. Again, the options available are rather limited. A common market for Euro-Bonds would help to restore confidence immediately. But without central fiscal agency monitoring fiscal prudence and applying sanctions to deviating states, such a step risks to pave an unpleasant route towards a transfer union. Luckily, they can be designed in an incentive compatible way even in the short run.

One route is to follow the idea of "blue" and "red bonds" as suggested by the Bruegel-Institute in Brussels. According to this proposal, common Euro-bonds (blue bonds) can be issued for each nation up to not more than 60% of GDP. This blue bond market would have an impressive size (€5,000 to €6,000 bn., comparable to the US Treasury bond market with €7,250 bn.). Any debt beyond that limit has to be financed unsecured on a national level (via red bonds). This way, market discipline is still imposed for countries with excessive spending. Critiques doubt the credibility of the 60% limit. If a country runs into trouble, it may be dynamically inconsistent not to raise this limit again. But as long as "blue" and "red bonds" are just an intermediate step towards a central fiscal authority, this should be a minor concern.

An alternative route is a more sophisticated version called ESBies (super save European bonds), proposed by a group of international economists around Markus Brunnermeier from Princeton. They apply techniques from modern financial engineering to create safe covered bonds which are not backed by tax payer money, but rather by splitting interest payments of current bonds in different tranches. A European Debt Agency (EDA) buys bonds of all Euro-area governments at a fixed weight (defined by the share of each country relative to common GDP) at market prices. Again, the nominal value of total bonds bought should not exceed a given percentage (say 60%) of total GDP. The bonds bought will be used as collateral to issue two types of securities. All interest payments will first go into the senior, super tranche called ESBies. ESBies are designed in such a way that their risk of default is negligible. In the future, the ECB will accept ESBies as preferred collateral. Thus, banks will primarily invest in ESBies to have sufficient funds for liquidity access at the ECB. The second (risky) junior tranche will absorb all losses on sovereign bonds bought; at the same time, they will have all upside potential from recoveries. Risk tolerant investors (like hedge funds) are natural holders of the junior tranche. The appealing feature of this proposal is that it uses modern financial engineering to create safe assets in a transparent way. They are a perfect instrument to prevent contagion effects from the default of sovereign bonds.

Certainly, neither of these proposals will be sufficient to solve the current crisis in the Euro-area. But they can help to calm down current market turm-oil and help to pave the way for proper changes in political governance structure in the medium term.