

# Gains for All: A proposal for a common Eurobond

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Until the eruption of the credit crisis in August 2007, financial markets were gripped by a ‘flight to risk’. The perception was that risks were very low. This perception was fed by the rating agencies that liberally distributed top ratings to dubious assets. Dulled by this low risk perception, investors and financial institutions accumulated vast amounts of risky assets on their balance sheets. Today the markets have moved to the other extreme and perceive risks everywhere. They are now gripped by a ‘flight to safety’. This has profound implications for the workings of the government bond markets in the eurozone.

Spreads of sovereign debt within the eurozone have increased dramatically during the last few months. Figure 1 shows the evidence of this. The governments of Greece and Ireland now (in February 2009) pay an interest rate on their debt that exceeds the German government bond rate by more than 250 basis points, while the governments of Portugal, Italy, Spain, Austria and Belgium have to pay more than 100 basis points extra. Thus, sovereign bonds with the same maturity but issued by different national governments are now perceived as imperfect substitutes.

Since all these bonds are expressed in the same currency: the euro, these spreads reflect either a pure default risk (assuming that the German bonds are free of default risk) or a liquidity risk. There is empirical evidence that part of the spreads are due to the fact that (with the exception of the German government bond market), the government bond markets in the eurozone have become less liquid (see Schwarz, 2008). This liquidity problem itself is due to the ‘flight to safety’ syndrome that has gripped the financial markets. This can be explained as follows. The panic that followed the banking crises has led investors into a stampede away from private debt into assets that are deemed safe. These are mainly the government bonds of a few countries that are perceived to provide safety. The US, Germany and possibly France are a few of these countries that have been singled out as harbours of safety. Other countries did not profit from the same ‘panic flight to safety’. This is shown in Figure 2, which presents the levels of the government bond rates in the eurozone. We observe a significant decline of the German government bond rate by more than 100 bp since November 2007. Germany was singled out by the market as the country offering safety. France also benefitted from this, but less so. With the exception of Greece and Ireland (and to a lesser degree Portugal), the other countries kept their

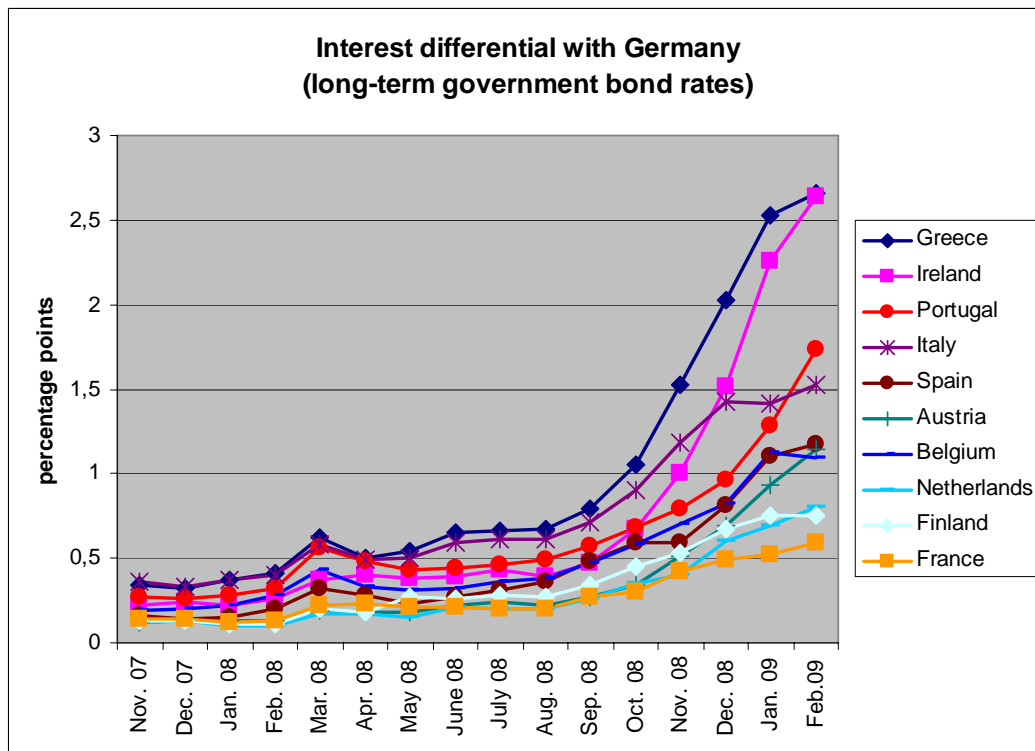
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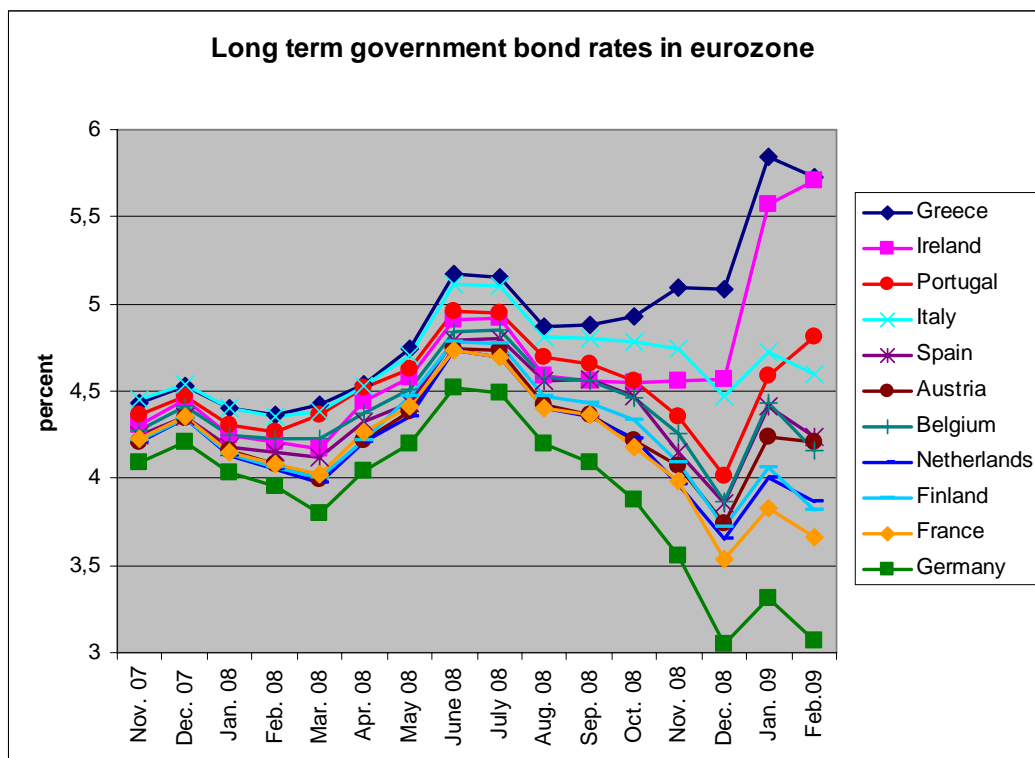
bond rates more or less unchanged (compared to a year ago) suggesting that these countries were bypassed by panicky investors. Only Greece and Ireland saw their bond rates increase significantly over the last year, suggesting that the increased spreads of these countries are not only due to panic, but have a country-specific cause.

Figure 1



Sources: ECB, <https://stats.ecb.int/stats/download/irs/irs/irs.pdf> and FT for Jan and Feb 09

Figure 2



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As a result of this flight to safety, the liquidity of most government bond markets in the eurozone has suffered, leading to an increased spread. (Note that we are not arguing that the whole of the spread is due to liquidity problems. Another part surely is also influenced by the perception that default risk has increased).

To the extent that these spreads reflect reduced liquidity, they create distortions. More specifically, the interest rate spreads faced by Southern European countries and Ireland are giving the governments of these countries incentives to reduce their efforts to stabilise their economies. Extra spending that leads to higher deficits is punished by a higher interest cost discouraging these countries from stimulating their economies. No such penalties are imposed on Germany and France.

In addition, these spreads create a perception of future default crises and impending fiscal doom, which impacts on the effectiveness of budgetary policies. We know that fears of future default crises reinforce the 'non-Keynesian' effects of fiscal policies, i.e. when agents fear such future crises they are more likely to react to budgetary stimulus by increasing their savings (see the well-known paper by Giavazzi & Pagano, 1996). As a result, budgetary stimulus packages lose their effectiveness.

The penalties imposed by increasing spreads on Southern European countries and Ireland also create negative externalities. For example, the rescue of banks in these countries is more expensive than in the rest of the eurozone, making it more difficult to resolve the banking crisis in these countries. This is likely to lead to a further weakening of economic activity in these countries with possible feedback again on the banking system, on the government budget deficits and on the ratings applied by the rating agencies.

How should one deal with these distortions and externalities?

It will remain difficult to prevent cycles of euphoria and panic from affecting perceptions of risk in the markets. Authorities can, however, attempt to offset the distorting effects these cycles produce. There are two possible approaches.

A first approach implies action by the European Central Bank. As the ECB will very soon be forced to engage in quantitative easing, it will be buying long-term assets, in particular government bonds. It should at that moment privilege the buying of Irish, Greek, Spanish and Italian government bonds. In doing so, it would increase the price of these bonds and reduce their yields. Thus, such a quantitative easing would tend to reduce the spreads in government bonds in the eurozone, and would reduce the distortions and externalities that these spreads create. It would also make it possible to stimulate the economies of all eurozone member countries, benefitting the whole area.

The second way to deal with the problem is through the issue of euro-denominated bonds that would be guaranteed collectively by the governments of the eurozone. These could be issued by a European institution such as the European Investment Bank (EIB), or directly by the member states' governments. (For a similar proposal see Gros & Micossi, 2009). In both cases the guarantee would be provided by those eurozone governments that have the taxing power to back up such a guarantee. The advantage of such a Eurobond issue is that countries that now face high spreads would have easier and cheaper access to the financing of their budgetary stimulus programmes. But this feature is also its drawback. Countries like Germany object. They fear that such a joint Eurobond issue will create a free riding problem. The governments of Ireland, Greece, Portugal, Italy, etc. which today face high spreads will have fewer incentives to conduct sustainable fiscal policies. As a result, the countries with low spreads, and especially Germany, may have to bail out the governments of these countries in case of default.

Whatever one may think of the motives of Germany, the German resistance to a joint Eurobond issue is a fact of life. The question then is whether this opposition can be reduced by going some way towards relieving German fears that it will have to foot the bills. Here is our proposal.

The Eurobond issue would have the following characteristics. First, each euro government would participate in the issue on the basis of its equity shares in the EIB. Second, the interest rate (coupon) on the Eurobond would be a weighed average of the yields observed in each government bond market at the moment of issue. The weights would also be given by the equity

shares in the EIB. Third, the proceeds of the bond issue would be channelled to each government using the same weights. Fourth, 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 Eurobond. Thus, using the February 2009 data, Greece (we use Greece here as the prototype high-risk country) would have to pay a yearly interest on its part of the outstanding bond of 5.7% while Germany would have to pay only 3.1%.

What are the advantages for the different countries involved? Let us concentrate on Germany first. Much of the fear that a common Eurobond issue would lead to a free riding problem forcing Germany to foot the bill disappears in this scheme. Greece would pay the interest rate it faces in the market today. Thus the incentive to free ride on Germany would diminish. In addition, in our proposed scheme Germany would pay the same interest rate it pays when issuing government bonds on its own. In this way, contrary to other proposals for joint Eurobond issues, Germany would not be penalised by a higher interest rate.

This leads to the question of what the benefits are for Greece. If Greece pays the same interest rate as it does when it issues bonds on its own, it may have little incentive to participate in a common Eurobond issue. We believe that Greece would also reap benefits from the common Eurobond proposed here. These benefits arise from the fact that Greece faces the problem that it may be shut out from the market, as long as the flight to safety syndrome exists. Thus the common Eurobond issue is a gate through which Greece can access funding, which it may not have as easily when it issues bonds on its own. And Greece would obtain this easier access without imposing burdens on the other participants of the scheme.

There are some practical problems to think about concerning the common issue of Eurobonds. We mention two here. The first relates to how the collective responsibilities underlying the bond issue are shared. If the common Eurobond issue is handled by the EIB, the national governments would be liable according to their equity shares in the EIB as is the case for normal EIB bond issues. A similar formula of collective liability could be spelled out if the common bond issue was carried out independently from the EIB;

A second issue relates to the possibility that the yield of the composite (common) bond differs from the (weighted) sum of the yields of the national bonds constituting the common bond. The issue is reminiscent of the divergences that occurred in the past with ECU-bonds. If our analysis is correct, i.e. that some of the high-yielding national bond markets have high yields because of a lack of liquidity, their inclusion in a composite common bond would implicitly increase their liquidity. As a result, the composite common bond would have a lower yield than the weighted sum of the constituting national bonds. This assumes of course that the common Eurobond market itself will have a sufficient size to make these bonds liquid instruments.

We conclude that it is possible to create an attractive common euro market for sovereign bonds. The formula proposed here avoids the free-rider problem that has marred previous proposals. In addition, on the demand side it will meet the desire for safety of investors and financial institutions, and on the supply side it will make it easier for sovereign borrowers with different needs to have access to the capital market. In a nutshell, it is a proposal that is 'Pareto optimal', i.e. it allows improvement of the welfare of some without reducing the welfare of others.

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