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Eurobonds, Flight to Quality, and TARGET2 Imbalances

Abstract
This brief shows how the introduction of eurobonds may provide an effective if still partial solution to some of the fundamental problems that have been raised during the sovereign debt crisis in the eurozone. In a five part analysis, it shows how the structure of European banking collateral and the geographic flight to quality across European financial markets have strong negative interactions in sovereign debt markets. The brief also considers the advantages and disadvantages that eurobonds would present as a potential solution to this underlying dynamic. The brief concludes by focusing on the challenges associated with implementation of any eurobond proposal. Although it makes some possible suggestions, the most important message from this analysis is that implementation should be the focus for debate. The time has come for Europe's political leaders to take a decision about whether to pursue eurobonds in principle.

Introduction
The debate over whether member states that have adopted the euro as a common currency should issue common sovereign debt instruments (or eurobonds) has receded into the background. The European Commission published its green paper to solicit comments on three different versions of what it renamed the 'stability bond' proposal on 23 November 2011 and then never followed up.[1] German political opposition to the idea was categorical, at least within much of the country's economics establishment and among the governing parties of the center-right.[2] Moreover, the Germans were hardly alone. The Dutch, the Finns, and the Slovaks were only among the most prominent in joining German opposition to the eurobond proposal.

Opposition to eurobonds is unlikely to soften in the near future. Although many commentators suggest that some manner of commonly issued and jointly underwritten sovereign debt instrument will come about eventually, even ardent supporters of the proposal, like Luxembourg Finance Minister Jean-Claude Juncker and Italian Prime Minister Mario Monti, admit that the moment is not ripe.

Meanwhile popular discussion about the eurozone crisis has moved onto more technical matters. Some of these issues are relatively easy to grasp, like concern expressed about the size and composition of the European Central Bank's (ECB) balance sheet. The ECB has accumulated large stocks of sovereign debt both as collateral against loans given to banks and through the direct purchase

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1 'Green Paper on the Feasibility of Introducing Stability Bonds.' Brussels: European Commission, COM(2011) 818 final, 23 November 2011.

2 The position taken by the former chief economist of the European Central Bank, Otmar Issing, is illustrative. See Otmar Issing, 'Why a Common Eurobond Isn't Such a Good Idea,' *Europe's World* (Summer 2009). More recently, Issing has been quoted as saying that a common eurobond represents the greatest threat to the stability of the eurozone. See the Eurointelligence daily briefing of 30 March 2012 at www.eurointelligence.com.

of government debt securities as part of the securities markets program. Others are more complicated, like the debate that has erupted over TARGET2 imbalances – or the relative positions of different national central banks in the real-time gross settlement system that is used to make financial payments across countries within the eurozone.

No matter how obscure such issues may seem, however, they are vitally important. The president of the German central bank (or Bundesbank), Jens Weidmann, created a minor scandal when the German daily *Frankfurter Allgemeine Zeitung* (FAZ) leaked a letter he wrote to ECB President Mario Draghi to complain about the growth and deterioration in the ECB's balance sheet and about the exposure of the Bundesbank to the rest of the eurozone through TARGET2 transfers.[3]

Weidmann's letter was followed closely by comments from former ECB Executive Board member Jürgen Stark, who argued that Europe's monetary policy makers risked undermining the stability of the euro through their aggressive extension of credit to banks under the long-term refinancing operations (LTROs) undertaken in December 2011 and February 2012.[4] These refinancing operations provided unlimited amounts of liquidity at very low rates of interest for periods of up to three years. In this way, the ECB fulfilled its role as lender of last resort – channelling roughly €1 trillion in new funds into the European banking system. Stark's concern was that the collateral received in exchange for this lending exposed the ECB to potentially unacceptable losses.

Draghi responded to both criticisms directly in his 8 March press conference but he could not silence the debate.[5] Even Weidmann's own attempts to minimize the significance of the controversy in an open letter to the *FAZ* on 13 March did little to ease concerns.[6] Hence Draghi returned to these themes more forcefully in his 26 March speech to the Association of German Banks.[7]

Such debates appear divorced from the idea of having European governments issue common debt instruments and yet they are not. To a large extent, the expansion of the ECB's balance sheet, the emergence of significant TARGET2 imbalances, and the necessity for the ECB to make extraordinary amounts of credit through the LTROs all stem from the fact that national governments in the eurozone issue national sovereign debt. The purpose of this brief is to suggest how the introduction of eurobonds might provide an effective if still only partial response to these more recent concerns.

The brief has five sections. The first explains how the collateral available to national banking systems and the geographic pattern of the flight to quality have influenced the current sovereign debt crisis. The second reintroduces the debate about eurobonds, focusing on the question of market discipline. The third examines some of the criticisms of the eurobond proposal related to moral hazard. The fourth connects this eurobond debate back to the problems of collateral and the flight to quality. The fifth sections concludes with policy recommendations related to the implementation of eurobonds.

Two problems

The argument about the potential utility of eurobonds hinges on two elements in the financial architecture of the eurozone: banking collateral and the flight to quality. The point about banking collateral touches on the relationship between national governments and their domestic banks; national governments and national banking systems are closely interdependent. Domestic banks offer a captive market for sovereign debt by helping to float new issues and by creating an active secondary market. Meanwhile, sovereign debt offers an essentially 'risk-free' asset to facilitate day-to-day banking operations by providing collateral for use in obtaining liquidity from central banks or for clearing transactions either bilaterally or with central clearing houses. However, this interdependence has negative as well as positive implications. When a country's domestic banks get into trouble, the governments lose access to the markets; when sovereign debt markets get into trouble, the domestic banks suffer disproportionate losses; and when sovereign debt markets get into trouble because the banks are already in trouble to begin with, the problems are self-reinforcing. This third

3 'Die Bundesbank fordert von der EZB bessere Sicherheiten,' *Frankfurter Allgemeine Zeitung* (29 February 2012).
4 Ambrose Evans-Pritchard, 'Germany's Monetary Doyen Slams ECB's "Shocking" Balance Sheet,' *The Telegraph* (8 March 2012).
5 http://www.ecb.int/press/pressconf/2012/html/is120308.en.html.
6 http://www.bundesbank.de/download/presse/publikationen/20120315.TARGET2_balances.pdf
7 http://www.ecb.int/press/key/date/2012/html/sp120326_1.en.html.

scenario where both the banks and the governments are in trouble at the same time is essentially what has happened to the countries of the eurozone periphery.

The Greek case offers a good example of the negative interdependence between banks and governments. When private sector investors were forced to accept a reduction in the value of the Greek bonds they were holding, the impact fell disproportionately on the Greek banking sector. As ECB President Mario Draghi explained during his 4 April 2012 press conference, private sector involvement in the Greek debt restructuring not only 'wiped out' the capital of the Greek banks but also left them without collateral to use in routine banking operations. Hence it was necessary to arrange a special recapitalization of the Greek banks in order to ensure that at least some of them survived the process.[8]

The flight to quality is what investors do with their money when faced with a sudden change in the risk environment. They liquidate investments that they perceive to be excessively risky and move the liquidity (or money) into investments that have a lower risk profile. This reaction describes the mechanism behind the crisis. It also explains why Europe is distinctive when compared with other large money unions like the United States.

In the United States, the flight to quality runs across asset classes. When investors in the United States take fright, they sell equity to buy fixed income; when the fright is extreme, they move up the fixed-income quality ladder until they end up holding large stocks of U.S. government bonds.

The flight to quality in Europe operates across asset classes as well, but it is also geographic. Frightened European investors sell their positions in the more risky or peripheral countries and increase their holdings in stable core economies like Germany. At the extreme, domestic investors from within the peripheral countries join the capital flight and take their money abroad. This geographic dimension of the flight to quality is what has damaged the economies on the periphery. As the money flowed out of the peripheral countries, their economies ground to a halt.[9]

These two different features of Europe's financial architecture work closely together. The geographic flight to quality damages both public finances and national banking systems, and any weakness in either public finances or national banking systems is enough to trigger a flight to quality. There is no fixed pattern to this dynamic. Whether the weakness of government finances triggers a capital flight that damages the banking system, as in Greece, or the weakness of the banking system triggers a capital flight that damages public finances, as in Spain, the consequences are the same and both the banks and the governments end up in trouble. Hence the challenge is to solve both structural problems at once.

There are two ways to manage the collateral problem. One is to place tight standards on eligibility rules; the other is to improve the quality of the collateral that is available. The first solution is difficult to enforce because of the inherent differences in the quality of assets in different markets. The last time the ECB made a concerted effort to strengthen its collateral rules was just prior to the collapse of Lehman Brothers; the ECB soon found itself loosening restrictions on available collateral instead in order to make sure that banks across the eurozone had ample access to liquidity.[10] The same tendency can be seen in the ECB's treatment of Greece, Ireland, and Portugal. Each time the national governments of these countries experienced a downgrade that could wipe out the eligibility of its debt as collateral, the ECB has made an exception to its collateral requirements so that the national banking systems of those countries could remain solvent.[11] The difficulty involved in enforcing collateral rules will not go away easily. The fact that the ECB signalled its intention to tighten its eligibility criteria is no guarantee that it will not find it necessary to loosen them up again.[12]

[8] http://www.ecb.int/press/pressconf/2012/html/is120404.en.html.
[9] Silvia Merler and Jean Pisani-Ferri, 'Sudden Stops in the Euro Area,' *Bruegel Policy Contribution* 2012/06 (March 2012).
[10] See Erik Jones, 'Reconsidering the Role of Ideas in Times of Crisis,' in Leila Simona Talani (ed.) *The Global Crash: Towards a New Global Financial Regime?* (London: Palgrave, 2010) pp. 64-66.
[11] See press releases from the ECB website (www.ecb.int) for 3 May 2010 (Greece), 31 March 2011 (Ireland), and 7 July 2011 (Portugal).
[12] Ralph Atkins, 'ECB Tightens Banks' Use of Assets as Collateral,' *Financial Times* (23 March 2012). Draghi sought to minimize the significance of this change in his 4 April 2012 press conference. http://www.ecb.int/press/pressconf/2012/html/is120404.en.html.

Improving the quality of collateral available is also difficult. Banks use sovereign debt as collateral because it is the closest thing available to a 'risk-free' asset. Hence the challenge is either to come up with a risk-free asset that does not depend upon the national government or to make sovereign debt less risky. This problem cannot be addressed within national boundaries. Either the banks will have to rely on assets from other countries, or other countries will have to absorb some of the risk of sovereign debt. This is essentially the problem that the ECB faces with those countries whose banks are in distress today. Such banks have been allowed to issue bonds with government backing as part of European Union (EU) and International Monetary Fund (IMF) assistance packages. In turn, the banks have been using these government-backed bonds as collateral in seeking liquidity from their national central banks. The question is whether other central banks should accept such bonds as collateral as well. On 23 March 2012, the ECB surprised the markets by suggesting that national central banks should approach the matter on a case-by-case basis rather than being expected to share the risks that such bonds necessarily entail.[13]

The flight to quality problem has only one solution. If the goal is to allow investors to move across asset classes and risk ratings without encouraging them to move across geographic boundaries, then the only way forward is to create a relatively 'risk-free' asset that circulates in all jurisdictions. Alternatively, some countries' risk-free assets will always be less risky than others and investors seeking quality will have to move money across national boundaries to take advantage of the difference.

A solution to all of this is to create a sovereign debt instrument that is less risky than existing government bonds and that can flow freely from one country to the next (so that domestic capital can stay put). This is essentially what eurobonds could offer. If European governments issued jointly underwritten eurobonds rather than relying exclusively on national sovereign debt instruments, then the flight to quality in Europe would not have to move geographically even if it continued to flow across asset classes (as in the United States). If European governments issued jointly underwritten common sovereign debt obligations, then governments could gain access to financing from wider markets and banks could rely on assets for collateral that did not depend on their home state.

The payoff for restructuring the flight to quality and improving the quality of existing collateral is considerable. If the flight to quality in Europe did not move across countries, there would be less pressure on TARGET2 imbalances to finance sudden gaps in international payments; if governments could rely on pan-European sources of financing, there would be less pressure on the ECB to shore up domestic sovereign debt markets through direct purchases of distressed sovereign debt; and if the aggregate balance sheets of national banking systems were not heavily exposed to losses on holdings of national sovereign debt instruments, there would be less pressure on the ECB to loosen its own collateral rules and provide additional liquidity to banks.

The existence of jointly underwritten common sovereign debt instruments like eurobonds would not solve all of Europe's financial problems. The United States also experienced the crisis – including intra-district imbalances in financial flows across the Federal Reserve System – despite the widespread use of U.S. Treasury bonds.[14] Nevertheless, by releasing some of the pressure, eurobonds would help stabilize the European financial system. Even if that is not the end of the problem, it is still a good start.

The problem is convincing a reluctant public – most of whom view eurobonds as a way for less creditworthy governments to escape market discipline at the expense of their more creditworthy neighbours. While economic conditions are good, the weaker countries will take advantage of low interest rates to borrow excessively; when economic conditions worsen, the weaker countries will default. In the worst case scenario, Europe's most creditworthy nations will end up absorbing the losses. The irony, of course, is that this worst case scenario is precisely what happened in the absence of eurobonds; indeed, excessive borrowing is that danger that eurobonds were meant to address.

Eurobonds as market discipline

Here it is useful to clear up some lexical confusion. Sovereign debt instruments denominated in euros have been around for a long time and the idea of allowing

13 See Draghi at http://www.ecb.int/press/pressconf/2012/html/is120404.en.html.

14 See the 6 March 2012 blog post by Michiel Bijlsma and Jasper Lukkezen of Bruegel (http://www.bruegel.org/blog/detail/article/696-target-2-of-the-ecb-vs-interdistrict-settlement-account-of-the-federal-reserve/).

European institutions to issue their own obligations dates back to the European Commission presidency of Jacques Delors. Both of these things – debt denominated in euros and obligations issued by European institutions – are called eurobonds. Moreover, prominent politicians like former Italian Prime Minister and European Commission President Romano Prodi continue to make proposals to deepen the market for euro-denominated obligations and to expand the issue of debt by European institutions. But such eurobonds are not what the debate is about.

The 'eurobonds' proposal at the heart of more recent controversy centers around the idea of having national governments issue common and jointly underwritten sovereign debt obligations. Such bonds will be denominated in euros and they will most likely be issued by a European institution. But what makes them distinctive is that they will be used to finance the member states individually and yet they will be backed by the member states collectively. That is what it means to say they are common and jointly underwritten sovereign debt obligations.

There is another distinguishing feature. The member states will have only limited access to sovereign debt financing through eurobonds. The reason is to discipline member state indebtedness – much in the same way that credit cards or current account overdrafts have limits. Here it is useful to consider that the original ambition was not to resolve the current sovereign debt crisis; it was to prevent such a crisis from occurring. Governments had already shown little restraint in their borrowing, European institutions did not enforce their own rules and regulations, and market participants failed to price in much of a difference in the cost of borrowing from one country to the next. Hence, the goal of the eurobond proposal was to change the structure of sovereign debt markets in order to enhance market discipline. Unsurprisingly, given this emphasis on market mechanisms, the first proposal to create eurobonds with limited access was introduced on the opinion pages of the *Wall Street Journal*.[15]

The idea underpinning the proposal is straightforward and uncontroversial: governments should have limits on what they can borrow responsibly and they should be discouraged from borrowing 'excessively'. The challenge is to get the markets to distinguish between responsible and excessive borrowing. There are two basic techniques; one focuses on the borrower and the other focuses on the borrowing itself.

The strategy embedded in the Maastricht Treaty that set the framework for monetary integration focuses on the borrower. Governments are enjoined not to run excessive deficits and they are sanctioned if they fail to comply. Experience has shown, however, that this strategy was unsuccessful for both political and economic reasons. Politically, the Council of Economic and Finance Ministers (Ecofin Council) proved both unable and unwilling to impose sanctions on offending governments. The February 2001 reprimand of the Irish government for failing to rein in its economy was rescinded; the February 2002 decision to ignore excessive deficits in Germany and Portugal turned out to be unjustified; and the November 2003 decision to hold the excessive deficits procedure for France and Germany 'in abeyance' was unlawful.[16] More recently, the debate about Spanish compliance (or non-compliance) with the new fiscal compact demonstrated that borrowers will resist restraint and lenders are reluctant to impose it. Economically, the markets have showed little interest in differentiating between different countries' sovereign debts until suddenly the spreads between the most- and least creditworthy countries widened dramatically, precipitating the current crisis.

The problem with focussing on the borrower is that it offers an all-or-nothing set of alternatives. The risk rating of a country influences all of its public debt. The price structure will change across different maturities, but within any given maturity both responsible and irresponsible borrowing are treated the same. Moreover, any default on one set of obligations constitutes a credit event for all the rest. This creates an important dynamic in how markets perceive national creditworthiness. The entire stock of a country's outstanding debt is affected once a country's solvency or liquidity is called into question. Long-term institutional investors that thought they had purchased virtually risk-free assets when a government appeared to be borrowing responsibly could find themselves taking substantial losses on those assets should the government's financial position suddenly change. This is the dynamic that has affected banks in countries like Ireland and Spain.

The eurobond proposal originally published in the *Wall Street Journal* offered an alternative approach

[15] John Springford, 'A Bonding Exercise for the Euroland,' *Wall Street Journal* (7 September 2009).
[16] See Erik Jones, 'The Politics of Europe 2004: Solidarity and Integration,' *Industrial Relations Journal* 36:6 (December 2005) p. 450.

to differentiating between responsible and excessive borrowing – one that focuses not on the borrower but on the debt. The reason for introducing eurobonds is to create a clear threshold between one type of borrowing and the other. It achieves this distinction by altering the structure of guarantees attached to the debt instruments. All participating countries would underwrite each-other's responsible borrowing by issuing a common series of obligations, and each country would be able to borrow with these obligations up to a fixed threshold of their gross domestic product (GDP). Any borrowing beyond that threshold would not be jointly underwritten and so the guarantees would vary from state to state. Given the different guarantees attached to the debt, the markets would charge a low price for the jointly underwritten bonds and a higher price for the nationally-specific bonds. Moreover, by eliminating this sudden transformation in the risk-rating of supposedly 'risk-free' assets, the eurobond proposal promised to mitigate the onset of any sovereign debt crisis.

The threshold effect is only one element in the debate and the eurobond proposals that evolved during the early months of 2010, included a number of different dimensions of distinctiveness between responsible borrowing and excessive borrowing.[17] In turn, each of these distinguishing features reinforced the price difference between eurobonds and national bonds, thus strengthening the market disincentive for countries to get excessively into debt. Some of these features are primarily structural. In this sense, they are also implicit in the original proposal. The eurobonds would trade in larger markets than country-specific bonds, and so they would be more liquid. Some of the features are primarily regulatory, in the sense that they depend upon other rules. The eurobonds could be designated as more 'senior', giving them a higher status in terms of repayment. Finally, some of the features are structural and yet also subject to regulatory reinforcement. For example, the eurobonds would make good collateral for clearing or for banking transactions because they would come with strong multi-national guarantees. It would also be possible to write collateral rules to strengthen this position by imposing large haircuts on national debt used as collateral or by making national bonds ineligible. This would make eurobonds not only more liquid and more senior, but also more useful for the banking community. Moreover, the combination of liquidity, seniority, and utility, should command a significant premium in the markets – reinforcing the price difference between relatively inexpensive eurobonds and relatively more expensive national obligations.

Finally, the eurobond proposals emphasized the importance of certification as a means of controlling the borrower as well as the borrowing. Governments would not qualify automatically to participate in the common funding pool. They would have to demonstrate an ability to manage their finances, they would have to accept more intrusive auditing, and they would have to demonstrate the capacity to meet their collective debt servicing requirements. Of course, the original proposal for Europe's single currency contained a number of similar criteria. The difference is that access to eurobond financing is an ongoing matter for governments and so the incentives for following the rules of membership would be constant; a government would have as much interest in retaining certification to raise funds through common eurobonds as they would in qualifying to issue such bonds in the first place. By contrast, accession to the eurozone was a one-off transformation. It was very hard for many of the candidate countries to meet the criteria for convergence in order to qualify for entry into the eurozone. As the Greek case shows, however, it would be even harder to see them leave.

The problem with these original eurobond proposals lay in their implementation: it would be difficult to introduce new senior eurobonds alongside existing national obligations; it would be challenging to enforce the thresholds on borrowing; and it would be hard to get both the ratings agencies and the wider community of market participants to buy into this new arrangement.[18] Moreover, these complexities only increase in the context of an ongoing sovereign debt crisis – when trading in the markets is relatively thin, investors are nervous, and any added complexity is likely to push capital out of the European marketplace altogether.

17 The most widely cited of these proposals is Jacques Delpla and Jakob von Weizsäcker, 'The Blue Bond Proposal,' *Bruegel Policy Brief* 2010/03 (May 2010). See also Erik Jones, 'A Eurobond Proposal to Promote Stability and Liquidity while Preventing Moral Hazard,' *ISPI Policy Brief* no. 180 (March 2010). For an early overview of proposals, see Guillermo De La Dehesa, 'Eurobonds: Concepts and Implications,' (Brussels: European Parliament, March 2011).

18 For further discussion of some of these issues, see Jacques Delpla and Jakob von Weizsäcker, 'Eurobonds: The Blue Bond Concept and Its Implications,' *Bruegel Policy Contribution* 2011/02 (March 2011).

Recognition of these implementation concerns led to a second round of debates about potential intermediate solutions – including a shared debt management agency, a common European bailout facility, or a European redemption pact.[19] Governments could issue all of their debt through an agency that they guaranteed directly; they could create a strong firewall to help those countries that get in trouble with their own debt management; or they could create a fund to finance all existing excessive borrowing against the promise that governments would not return to further irresponsible behaviour. Such intermediate proposals did alleviate some of the complexity of implementing eurobonds but only by increasing the complexity of their design. These proposals also blurred the market's ability to perceive the distinction between responsible and excessive borrowing and so weakened the benefits to be had from strengthening market discipline. In short, they offered advantages in the context of the ongoing crisis but at the expense of preventing the next one. The problems of close interdependence between national governments and their domestic banking systems and arising from the geographic flight to quality remain unaddressed.

Moral hazard, borrowing costs, and loss provision

The intermediate proposals for eurobonds also failed to address the most potent criticisms of the original proposal to encourage member states to issue common, jointly underwritten sovereign debt instruments: Opponents of the proposals expressed concern that eurobonds would increase moral hazard by allowing less creditworthy participants to borrow more cheaply; they worried that eurobonds would create conditional liabilities for more creditworthy borrowers that would lead to lower ratings and higher borrowing costs on even the most responsible participants; and they feared that the withdrawal of individual participants or the spectacular collapse of the system would leave the strongest countries in Europe to cover any losses. In other words, although the original eurobond proposal was designed to increase market discipline, nothing in either the proposal or its intermediate alternatives addressed the concerns that define a large part of public opinion today. Therefore, it is worth considering the logic of these positions more carefully.

The concern about moral hazard returns the focus for market discipline to the borrower and not the borrowing. The argument is that eurbonds will create perverse incentives. By lowering the cost of responsible borrowing, eurobonds effectively release resources to service excessive deficits. They also shift the focus for political discipline from the imposition of sanctions to the enforcement of the borrowing thresholds. And yet since European politicians have shown themselves incapable of imposing sanctions, there is little reason to assume that they will be more effective in imposing restrictions on common debt issuance. Finally, eurobonds take pressure off of governments in need of politically painful and yet economically necessary reforms. Without the threat of crisis, such governments are more likely to delay making structural adjustments.[20]

The concern about conditional liabilities also focuses attention on borrowers. The problem is that while national governments have individual credit ratings, the pool of eurobonds as a whole would be jointly underwritten. Hence the ratings agencies would be justified in looking at the potential losses that any one country could face in the event of a breakdown within the system when making assessments of a country's creditworthiness. The extent of any likely breakdown is an important factor as well. At a minimum, the stronger countries would have to be able to take on the debt servicing requirements of the weakest. Given that this would effectively increase liabilities for the strongest participants, it should be expected to raise their borrowing costs and put downward pressure on their credit ratings. The German ministry of finance estimates that participation in such a system would cost Germany billions of euros.[21] While the liabilities are conditional, the costs to Germany are real. Even if the eurobonds work perfectly as a commonly issued and jointly underwritten sovereign debt instrument, Germany would pay a price for its exposure to the system.

The concern about loss provision stems from the possibility that the system will not work perfectly. The question is who will pick up the costs if the eurobond arrangement fails. This is where moral hazard and conditional liabilities come together to create a fear that unscrupulous governments will repudiate their obligations

[19] See Alexander Duering and Abhishek Singhania, 'A Modest Eurobond Proposal,' *Deutsche Bank Fixed Income Special Report* (25 August 2011); Hans-Joachim Dübel, 'Partial Sovereign Bond Insurance by the Eurozone: A More Efficient Alternative to the Blue (Euro-) Bonds,' *CEPS Policy Brief* No. 252 (August 2011); Bofinger, Peter, et al. 'A European Redemption Pact,' *VoxEU* (9 November 2011).

[20] See Duering and Singhania, 'A Modest Eurobond Proposal,' (2011) above. See also 'Eurobonds: Moral Hazard Ahead,' *Financial Times* (23 November 2011).

[21] 'Euro Bonds Would Cost Germany Billions,' *Spiegel Online International* (22 August 2011) http://www.spiegel.de/international/germany/0,1518,781524,00.html.

to the system, thus leaving governments that respect their obligations to carry more than their fair share.

These concerns are compelling. They also appear to be happening even without eurobonds. Indeed that is why Jens Weidmann expressed alarm about Germany's TARGET2 position. Although he claims in his 13 March letter that he does not believe the eurozone will come apart, the only reason for collateralizing TARGET2 imbalances is to have some asset in place to absorb the losses should one or more countries pull out of the system. The concern about conditional liabilities is evident today as well. This is why Jürgen Stark expressed skepticism about the size of the ECB's balance sheet and why he is so critical of the assets the ECB accepts as collateral. Finally, such concerns explain why the preponderance of German public opinion is so critical of the governments on the eurozone periphery. Here it is useful to cite a speech Stark made while he was still an ECB Board Member: [22]

> In my view solving the current sovereign debt crisis is primarily in the hands of governments. Its root cause lies in lax fiscal policy rules and associated deteriorating public finances in some euro area countries. Stability criteria were violated, fiscal rules ignored and statistics tweaked. Growth dividends were not used for necessary consolidation in good times. In the same vein, competitiveness positions worsened in many euro area countries, due to a lack of structural reforms.

This is a near perfect illustration of moral hazard.[23]

Full circle

Yet if the worst fears of the eurobond's opponents are already evident, it is worth considering how they came to pass. Many parts of the story are already evident. National governments took advantage of the system and European institutions failed to enforce the rules. Yet such features are ubiquitous. They are as easily found in any of the possible alternatives. Countries outside the eurozone – like Iceland or Hungary – have also been affected. Meanwhile countries like Ireland, Portugal, Spain, Italy, and Greece are more different than they are similar. Somehow the problem is structural and not national; if the question is what caused the crisis, original sin is not the answer.

A better analysis looks at the problems of geographic capital movements and collateral rules. Only rather than focussing on distress and uncertainty, it looks at opportunity and return. During the run-up to monetary union, investors at the core of the eurozone sought opportunities on the periphery and the most creditworthy banks looked for relatively risk-free assets that offered a higher rate of return. This is why long run interest rates across sovereign debt obligations converged so sharply across European countries during the late 1990s; it is why cross border deposits expanded in the smaller, peripheral markets; and it is why the economies of the eurozone periphery experienced relatively high rates of debt-fuelled growth.

The result of the process can be seen in the prolonged period of tight interest rate differentials during the first decade of monetary integration and the large cross-border exposures of the national banking systems and sovereign debt markets that built up over the same period. Indeed, it is this prior outward flow of capital from the core to the periphery that explains the depth of the crisis once the flow moved in reverse. Geographic capital flows and collateral rules played as important a role in setting the stage for the current crisis as they did in bringing down the curtain.

There is little reason to believe that the cycle will not repeat itself. The impact of capital market integration in times of economic stability is to move savings from countries with relatively low rates of return and scarce opportunities for investment to countries with relatively higher rates of return and more abundant opportunities for investment. The flows during the next cycle do not need to be as great as they were the last time; all that matters is that the stock of cross border exposure builds up over time. The impact of capital market integration in times of economic uncertainty is a rapid unwinding of these accumulated positions. As large amounts of funds flow suddenly back to countries with surplus savings and relatively few opportunities for investment, the net effect will be to slow economic performance across the area of integrated capital markets as a whole.

The difference between a eurozone with eurobonds and a eurozone without them is not to be found in the quality of political leadership or its willingness to abide by solemn commitments. Rather it is found in the structure of market incentives and the costs of violating the rules. The strength of the eurobond proposal is that it provides more

[22] http://www.ecb.int/press/key/date/2011/html/sp111202.en.html.

[23] Stark's analysis is obviously inaccurate. Neither Ireland nor Spain had fiscal problems before the crisis. Their problems were more closely related to the growth of private debt. The governments only got into trouble once the private debtors needed to be bailed out.

opportunities for continuous enforcement than the all-or-nothing alternatives offered in the current system. It creates incentives for countries to allow for more intrusive monitoring and it reduces incentives for banks or other financial actors to attempt to arbitrage price differentials within a pan-European framework of rules. Of course such a system will be prone to manipulation, but so is the status quo. On balance, however, the structure of incentives in a eurozone containing eurobonds will bring more stability to the system rather than encouraging oscillations. So long as governments depend upon national obligations, they are likely to suffer further turmoil.

Policy recommendations

No matter how attractive eurobonds might be as a proposal, there are significant challenges to be tackled before they can be implemented. Hence the basic recommendation is that these implementation challenges should be placed at the forefront of the debate. The time for considering whether eurobonds are justified in principle has elapsed. The European Commission's green paper should have put an end to that phase of discussion. Now the challenge is to take it further.

The first step could be to harmonize and strengthen the collateral available to banks across the eurozone. This could be done by swapping out the banking books of the pan-European banking system at par value, using jointly underwritten sovereign debt instruments. For many of the banks, this will insulate them from potential losses like those experienced in Greece as part of private sector involvement. The ECB's exposure to sovereign debt instruments – both outright and pledged – should be swapped out as well. This will not increase the contingent liabilities of the participating governments. It is already evident from the 'open sector involvement' debate during the second Greek bailout negotiations that these assets are effectively 'senior' to those held in the private sector. By swapping them out, the eurozone governments will only make that seniority more explicit.

The next step could be to offer distressed countries the opportunity to refinance their debt as it comes due in these new eurobonds in exchange for intrusive auditing and monitoring. This is already happening in those countries that have requested official assistance; it could be made available to all governments in the eurozone on the same conditions. Governments in sound fiscal situations might object that they do not require such supervision; but their demonstration of solidarity would help mollify public opinion in those countries most needing reform. In any event, there would be cost advantages to participating in jointly underwritten sovereign debt issuance, particularly if collateral rules were shaped to privilege these assets for use in obtaining bank liquidity or in clearing.

The remaining challenge will be to enforce the thresholds for issuance, particularly for those countries most indebted. The original eurobond proposal was designed to prevent a crisis and not to solve one. Now that it is too late to prevent a crisis, it is probably too soon to unleash market discipline on distressed governments. That said, there is no reason that governments cannot be coaxed back into the markets at some point in the future. Therefore, while it may be necessary to swap out a country's entire existing stock of debt with eurobonds in the short term, it should be possible to refinance any excess borrowing with strictly national sovereign debt instruments incrementally once the government is able to re-enter the markets. That is essentially what the European bailout mechanisms intend. The financing they provide offers only temporary relief from market pressures and should at some point be paid back as the government regains market confidence. There is no reason that the introduction of eurobonds could not provide similar exceptional and temporary relief.

In the final analysis, Europe will have to move to a system that focuses on the borrowing and not the borrower. It will need to stop the geographic flight to quality and it will have to break the strong interdependence between national banking systems and their domestic governments. Otherwise Europe's policymakers will continue to find themselves periodically descending into crisis. They will overstretch their monetary institutions and may even undermine the eurozone as a whole. These questions are all linked by the structure of the system. The eurozone as a whole needs structural reform.

Eurobonds offer a partial if still effective solution. They would make it easier to channel the flight to quality across asset class without necessary forcing capital to flow across national boundaries. They will disconnect sovereign access to borrowing from the solvency and liquidity of national banking systems. They will provide strong guarantees for the assets held on the balance sheets of European monetary institutions. And they will relieve at least some of the pressure that has built up across the European financial system.

Of course politicians must still address concerns about moral hazard and abuse of the system. Those problems will not go away and critics of the eurobond proposal are right to point at that jointly underwritten and commonly issued sovereign debt instruments are vulnerable. But the point that should be stressed is that the current crisis is a result of moral hazard under the existing system. Moreover, by focusing on the borrower and not the borrowing, the existing framework for reining in excessive deficits puts governments in an unenviable all-or-nothing situation where the incentives for ignoring the rules or refusing to enforce them are very hard to ignore. Solemn declarations and inverted decision making procedures are not enough to reshape the structure of these incentives. Europe's political leaders must look for some more fundamental solution. At least part of that solution will be found in the eurobond proposal.

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