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A Eurobond Proposal to Promote Stability and Liquidity while Preventing Moral Hazard*

The current crisis in Greek sovereign debt markets has made two things clear. First, any default by the Greek government would be bad for the eurozone as a whole because it would hurt the balance sheets of large banks that are already struggling to raise capital and because it would threaten the liquidity of bond markets for countries that may be in a similar situation. Hence a timely bailout of the Greek government would do a lot to shore up the stability and liquidity of European financial markets. Nevertheless, and this is the second point, no-one is particularly eager to (be seen to) bail out the Greeks. Of course everyone is eager to prevent another major financial crisis but the idea of pumping money into a country that has so obviously lived beyond its means while at the same time cooking the books and conniving with banks to cover its tracks is hard to swallow. Even under the most generous of circumstances, such an action would be seen to create a “moral hazard” – encouraging future governments in Greece and

elsewhere to engage in similar behavior.

The current situation in Greece presents precisely the sort damned-if-you-do, damned-if-you-don't dilemma that the Maastricht Treaty and the Stability and Growth Pact were designed to prevent. The multilateral surveillance, excessive deficits, and early warning procedures were meant to spot and correct these situations in a timely manner; ESA 95 and the newly empowered Eurostat were meant to ensure that fiscal accounting was easy for all to read; the escalating ladder of sanctions provided the incentives for corrective action; and the no bailout clause showed that there was no net on the other side of the precipice. Unfortunately, however, few economic commentators recognized that the Greek situation was a real possibility. Instead they worried that the provisions for macro-economic policy coordination would leave too little room for fiscal stimulus or policy flexibility. Hence it is hardly surprising that politicians would use this concern to set the stability and growth

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Abstract

No-one is particularly eager to bail out the Greeks. Of course everyone would like to prevent another major financial crisis but the idea of pumping money into a country that has so obviously lived beyond its means while providing incorrect information and conniving with banks to cover its tracks is hard to swallow. Even under the most generous of circumstances, such an action would be seen to create a “moral hazard” – encouraging future governments in Greece and elsewhere to engage in similar behaviour.

The solution could be a dual bond structure for government financing (including Eurobonds). This would not eliminate the Greek crisis but would help mitigate its systemic importance.

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(*) Further institutional, juridical and technical details on this proposal will be provided in a future ISPI publication.

pact aside at the first sign of inconvenience. The Greek situation is the natural outcome of this lack of restraint¹.

The question is where to go from here. Two ideas that have been floated are a European stability fund to shore up the financial system and a common issue "Eurobond" to ensure that adequate liquidity is available to all member states². These ideas have tight synergies and they could even be run together. They also share the same problem: moral hazard. As Otmar Issing insisted in criticizing such proposals: «a common bond is no cure for a lack of fiscal discipline; on the contrary, it would tend to encourage countries to continue on their wrong fiscal course»³. Still the alternatives seem even more unpalatable. The International Monetary Fund could be called in to give a Greek bailout the veneer of international respectability or Greece could be pushed out of (invited to take a holiday from) the eurozone altogether⁴.

¹ J. MATTHES, *Why the IMF should be involved in solving imminent fiscal debt crises in Eurozone countries*, in «VoxEU», February 27, 2010.

² D. GROS - S. MICOSSI, *A bond-issuing stability fund could rescue Europe*, in «Europe's World», Spring 2009; P. DE GRAUWE - W. MOESEN, *Gains for All: A proposal for a common Eurobond*, CEPS Commentary, April 3, 2009.

³ O. ISSING, *Why a common eurozone bond isn't such a good idea*, in «Europe's World», Summer 2009.

⁴ J. MATTHES, cit.; M. FELDSTEIN, *Let Greece take a eurozone*

Clearly, what we need is the best of both worlds – a proposal that can provide liquidity in a crisis but with the teeth to ensure that governments have an incentive to keep their fiscal situation under control. Such a proposal should also offer advantages to all parties, both those countries that are likely to wind up in difficulty and those who are more likely to do the bailing out. Finally, the proposal should not rely on a nuclear option that lacks credibility because it is too painful or embarrassing to enforce.

Eurobonds for Growth and Stability

The eurozone needs a common sovereign bond issue to provide liquidity and to avoid market speculation (or a flight to security) from resulting in cross-country financing strains⁵. Member state governments would authorize bond issues for which they would meet the servicing requirements. Nevertheless, the bonds would come from a central issuing authority and would be both indistinguishable and interchangeable in secondary markets – one bond would be much as another (of the same coupon and maturity) no matter which country

"holiday", in «Financial Times», February 16, 2010.

⁵ M.G. ATTINASI - C. CHECHERITA - C. NICKEL, *What explains the surge in euro-area sovereign spreads during the financial crisis of 2007-2009?*, in «VoxEU», January 11, 2010.

authorized its issuance. In other words, all eurobonds with the same characteristics would attract the same ratings.

To avoid moral hazard, participating governments would have limits on the volume of bonds they can authorize both globally and in any given year. Specifically, they would be constrained from authorizing bonds worth more than 60 percent of their growth domestic product or – after an initial transition period – from authorizing a net increase in their total eurobond responsibilities worth more than 3 percent of their gross domestic product on an annual basis. In this sense, eurobonds would only be available for responsible borrowing.

“Excessive” borrowing, as defined by the Maastricht Treaty, would have to take place through national sovereign bond issues which would be characteristically different both from common issue eurobonds and across countries – and so attract a different rating and price from one country to the next. Hence the first incentive to engage in responsible borrowing would be the price differential. Responsible borrowing would be cheaper; excessive borrowing would be more expensive.

The major advantage of this arrangement would be the heightened transparency that it would provide both in terms of financial markets and in terms of the countries

themselves. Market participants would know exactly not only how much “excessive” borrowing a country was engaged in but also which of a country’s debt instruments are most susceptible to the risk of sovereign default. Moreover, the countries that choose to participate in the common bond issuance would have to accept much closer scrutiny of their national statistics and fiscal accounts – just as firms that trade publicly on the stock exchange agree to stricter reporting requirements. If a country was shown to be cooking the books, its authorization privileges could be suspended, forcing it to rely on more expensive forms of borrowing until it could earn the right to authorize common issue eurobonds again.

In extremis, this dual bond arrangement suggests a natural procedure for organizing a country’s orderly default. The first stage would be to renegotiate the terms of country-specific obligations – meaning those used for any excessive borrowing – followed if necessary by a suspension of debt servicing payments on the common issue bonds (which could continue to roll-over unaffected by any country-specific financial situation). Here it is true that the other member states would be required to pick up the defaulting country’s debt servicing obligations. However, this would only be temporary, it would represent

far less of a financial exposure than actively bailing the country out, and it could always be repaid with interest once the crisis has passed and the country’s financial situation is on more stable footing.

Deeper Markets, Cheaper Liquidity

The incentives constraining fiscal policy under this proposal are easy to summarize: countries face a higher price for excessive borrowing; they run the risk of losing their authorization privileges; and they can imagine what it will look like to experience an orderly (and yet still humiliating and painful) default. These incentives do not include an unbelievable nuclear option; there is no need to expel a country from the eurozone, to call in the IMF, or, alternatively, to bail them out. The structure of the system also shores up the procedures of the rest of the eurozone. For example, the European Central Bank is no longer held responsible for certifying all sovereign debt instruments as collateral in open market operations or, reciprocally, for triggering a sovereign debt crisis once eligibility for collateral use in open market operations is withdrawn. Hence, on the disciplinary side, it is a credible arrangement all the way down.

But what about the incentives for otherwise responsible countries to

participate? These are fairly straightforward as well. To begin with, the common issue eurobond offers a deeper and more liquid market than any country – even Germany – can generate for itself. Hence to the extent that liquidity trades at a discount, it should offer lower borrowing costs for all countries (including Germany) as well. Moreover, because it is larger than any national market, this eurobond market would make it possible for countries to export savings across the eurozone without accepting an implicit sovereign risk. This would make it easier for Germany to continue to run its export-led growth model without exposing its banking system to the need to take on unwanted exposure. A deeper eurobond market would make it more attractive for countries outside the eurozone to diversify their reserve holdings into euros as well. Indeed, since this common issue eurobond would be limited in scope to what we can characterize as responsible fiscal borrowing, it might prove even more attractive than the ever expanding market for government paper in the United States.

Getting There from Here

If we had this dual bond structure for government financing, the current crisis in Greece would be less pressing and more manageable. It would be less

pressing because not all Greek debt would come up for refinancing in nationally specific sovereign bonds. Much of it would come up as eurobonds instead. This would not eliminate the crisis in Greek public financing, but it would mitigate its systemic importance because in effect, investors could fly to safety from one set of Greek obligations to another. This would benefit both Greece and the investors who hold Greek obligations. Meanwhile, the crisis would be more manageable because we could know better how to structure a reorganization of Greek finances transparently, making it clear to all who is exposed to losses and who is not.

The trick is to get there from here. It is possible to imagine two alternatives. One is to wait for this crisis to pass, taking the time to organize the institutions for issuing and overseeing the common issue eurobonds and for preparing national fiscal authorities (and their treasury operations) for the necessary transition. That may prove the most rational way forward. However, time is not on our side. Hence it could be possible to imagine a more speedy process, which sets up the institutions for eurobond issuance quickly so that the resources they promise can soon be put into place. This would allow the member states to begin refinancing Greek sovereign obligations with common issue eurobonds almost immediately, stabilizing

financial markets by pooling those obligations with issues authorized by other member states. Technically this would not be a bailout. Practically, it would take much of the urgency away. Not only would we eliminate the current crisis, but we would create the incentives to avoid the next.

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