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The creation of a common European bond market

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European League for Economic Cooperation, a.i.s.b.l.

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FOREWORD

The introduction of a common European currency some ten years ago has been a blessing for the participating countries. When the financial crisis broke out in 2008, the sixteen countries that had given up their national currency for the euro were protected by the "firewall" of the Monetary Union. It is not hard to imagine that without the existence of the euro, the wave of distrust that hit banks and stock markets, would have put fire to national currencies too, provoking a currency crisis like the ones Europe has experienced so often since the end of Bretton Woods.

But at the same time the financial crisis has shown that imbalances within the euro zone still exist. Interest rate differentials between government bond issues of participating countries that had almost completely disappeared after the introduction of the euro reemerged. Worse yet, it appeared that speculation against the very existence of the euro is still possible.

The tensions that arose on the national government bond markets – with Greece as a leading actor in this drama – have rekindled the debate whether a common European bond market is not a missing link for a successful common European currency. Of course, one can argue that creating a common market in government bonds without creating a common fiscal policy that gives rise to common deficits and common funding, is like putting the cart before the horses. But on the other hand, is the same reasoning not true for the introduction of the euro itself? The euro has proved to be successful despite similar criticism that a monetary union would not be possible before an economic union or even a political union was put into place.

A common European bond market would certainly deepen the Monetary Union. But the question is: is a common European bond market possible and feasible in the present circumstances? Opinions differ. A major obstacle seems to be the "no bail-out" clause that is a centerpiece of the Maastricht Treaty on Monetary Union and that is essential for fiscal discipline in individual countries. But member states not showing solidarity to share burdens is a contradiction to common deficit funding. Much of the discussion then comes down to the question whether both strong and weak economies benefit from a common bond market. And if so, how to convince them of this.

Of course, as always in the long history of European integration, everything is possible if political will exists. After the fall of the Berlin Wall, the political will was present to go further in European economic and financial integration by creating a common currency. Is the European Union after the financial crisis determined enough to go a step further into monetary integration?

The debate on the pros and cons of creating a common European bond market often sounds like a discussion between "believers" and "non-believers". But even if it is a matter of believing, a minimum of facts and figures is necessary before one can make a judgment.

That is why the European League for Economic Cooperation with its long standing record of encouraging progress in the various discussions of European integration, was keen to reopen the debate on the common European bond market. In December 2009 the members of ELEC's Monetary Commission participated in a lively discussion of several papers representing the (sometimes conflicting) views on the issue.

We wish to thank in particular the authors of the papers who were so kind to publish them in this "Cahier Boël". Neither ELEC nor its members are committed to endorse the views expressed in this "Cahier", which remain the responsibility of the authors. Moreover, the authors write in their personal capacity and do not necessarily represent the view of their institution or company.

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Part I: How EMU can be strengthened by central funding of public deficits

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Introduction

An important lesson from the financial crisis is that the euro has served its member states very well. However, at times the common currency has experienced periods in which it was severely under pressure. On the currency markets, the euro lost substantially value vis-a-vis the US dollar between June and December 2008. This happened after a number of years in which the euro steadily increased in value against the dollar (2005 being the exception).

In the aftermath of the eruption of the financial crisis in October 2008, interest rate differentials within the eurozone initially rose steeply. This happened after years in which markets failed to differentiate between public bonds of countries with sound public finances and those with a poorer track record in this respect. This resulted into speculation in the markets that the euro might break up under the tensions. More recently, these tensions gradually abated. However, although the worst appears to be over, there are lessons to be learned and improvements to be made. Because repetition of these events are very likely, as is illustrated by the very recent unrest around the Greek public finances.

Various ideas have been put forward in the course of the year to tackle the problems facing the EMU and the euro. One of them is to issue a 'eurobond' to fund support for member states that need help. Another is to fund government deficits of eurozone member states centrally (De Grauwe & Moessen, 2009; Münchau, 2009). Be it one way or the other, the euro needs to be institutionally strengthened, because Europe cannot avoid taking effective measures if it is to come out of the current crisis with as little damage as possible and, better still, come out of it stronger. This contribution therefore presents a proposal aimed at helping to advance European financial integration. Specifically, it advocates central funding of government deficits in the eurozone on a basis that minimises interference with the budgetary autonomy of countries and avoids undermining the European 'no bailout' clause. At the same time a mechanism is put in place to tighten the budgetary discipline of participating countries.

[1] Wim Boonstra is President of ELEC Monetary Panel and Chief Economist of Rabobank, Utrecht, The Netherlands. He also lectures at VU University, Amsterdam. This paper, which is a shortened version of Boonstra (2010), has gained much by critical, constructive comments from Allard Bruinshoofd, Paul N. Goldschmidt, Tim Legierse and Jean-Jacques Rey.

Why and how to strengthen EMU?

Although monetary integration of EMU is complete, political and fiscal integration of Europe has still a long way to go. EMU needs a credible mechanism to discipline countries in their fiscal behaviour. It also needs a deepening of its financial markets in order to improve their liquidity, which is not really possible as long as the supply side of its government bond markets is fragmented into national segments. Finally, it is important that individual member states are sheltered from sudden swings in sentiment on financial markets, that in today's situation even can deny them access to finance. This can in turn translate into speculation that countries may leave EMU, voluntarily or forced [2].

As long as speculation about its demise will occasionally pop-up, the euro will be relatively vulnerable in comparison to the US dollar. Therefore, it is important to further strengthen the euro. A major intensification of European cooperation and institutional strengthening of the euro would be achieved if a common public budget were indeed to be introduced in Europe. This would be a major step, but one which at present is still completely unrealistic. The political basis for such a step has always been slender and is currently contracting further rather than growing. Subsequent generations may one day wish to take this step, but an EMU-wide common budget is at present still a long way beyond the horizon.

Another way of strengthening the euro can be sought in the creation of a pan-EMU bond market. One option launched recently by Nauschnigg (2009) is to issue EU bonds for a so-called Euro financing facility. Also De Grauwe & Moesen (2009) have proposed the issuance of common euro bonds, while Mayer (2009) advises the establishment of a European Monetary Fund. Delpla (2010) also has presented a innovative scheme of partly common funding of European budget deficits. [3]

Although the creation of these facilities will certainly strengthen the euro bond market, this new market segment would either still remain small compared to most national public bond markets (like the proposals by Nauschnigg and De Grauwe & Moessen), or do not solve the problem of market failures in normal times. Moreover, the public bond market within EMU, already too fragmented, would see another public bond issuer. Fragmentation would further increase, instead of decreasing. The Delpla proposal is an exception to this observation. A more drastic step would be the step to central funding of all government deficits within the eurozone, but in a way that tightens rather than threatens countries' budgetary discipline.

Central funding of public deficits in the EMU

It would be a good thing if the euro could be strengthened in a way that both gives the member states of the EMU greater freedom in their budgetary policy,

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2 See Boonstra (2010) for a more extensive analysis of the vulnerability of EMU.

3 A description of the Delpla proposal can be found elsewhere in this Cahier Boël.

that enhances the disciplinary effect of the financial markets and helps to parry the fragmentation of the European bond market. The cardinal element of the proposal presented in what follows is that all member states of the EMU in principle remain as free or constrained in their budgetary policy as is the case at present, except for the way in which the deficit is funded. This means, specifically, that they must impose a number of restrictions on themselves with regard to the funding of the deficit. The arrangements to be agreed upon are as follows:

1. Government deficits must not be financed on a monetary basis. This rule was already laid down and hence endorsed by all member states in the Maastricht Treaty. [4]
2. Government deficits must from now on only be funded by the intervention of a new central funding institution to be created. This institution is referred to here as the EMU fund. This means that government debtors may no longer directly turn to the capital market or private lenders. [5]
3. This EMU fund directly finances itself by means of the issue of bonds and other debt instruments in the financial markets. The funds raised in this way are passed on to the governments of the EMU member states, for which the EMU fund charges the various governments a fee comprising its own funding costs plus a margin.
4. This margin, which can be either positive or negative, is determined by reference to the relative performance of the member state concerned in the field of public finances. Criteria can include the government deficit, outstanding government debt and the share of the public sector in the economy, with the performance of the individual countries always being measured against the average within the EMU.
5. Ideally, the sum of these margins equals zero; in that case the EMU fund is deemed to break even. However, this restriction can lead complications in establishing the spread. Therefore, a more simple approach is put forward further in this article. In addition the EMU fund is expected not to enter into an open interest position. It only acts as a channel for passing on funds. [6]
6. Countries that break the rules – that for example start with monetary financing, fail to pay their spread or directly approach financial markets for funding - must immediately be punished severely. This can include losing funds from the European budget such as the regional funds and losing political influence or the voting right in the bodies of the European Central Bank.

[4] Note, however, that today banks one the hand borrow heavily with the ECB and on the other hold huge liquid reserves in the form of short term government bonds. This is so-called indirect monetary financing.

[5] One could consider to let this central institution also handle the funding activities of other European bodies as well in future, such as the European Investment Bank, EURATOM, and even the European Bank for Reconstruction and Development (although this is not a pure EU institution). However, as the EMU Fund only deals with the funding activities of (a group) of EMU member states and the other EU institutions work for all EU-members, it seems better to restrict the activities of the new fund to the central funding of public deficits of member of EMU. This argument was put forward by Paul N. Goldschmidt.

[6] However, this restriction may be dropped for the sake of simplicity. See below.

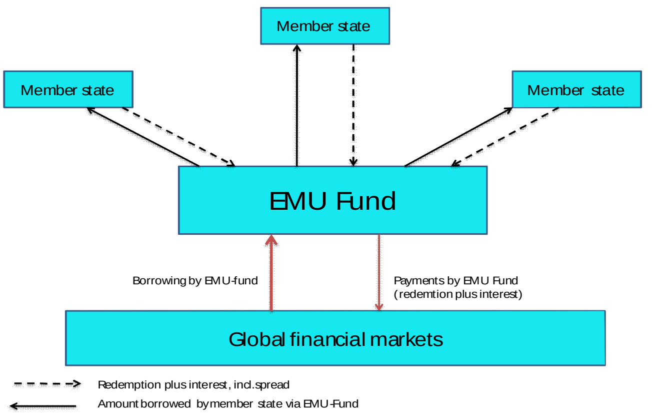
Advantages of the EMU fund

Establishing the EMU fund as outlined offers a number of evident advantages, for both the budget policy of the various member states of the EMU and for the effectiveness of the European financial markets. With regard to the first, it can be pointed out, for a start, that the fund can be introduced without significantly affecting the far-reaching autonomy in budgetary policy that the member states currently still possess. The EMU fund could also be used as an additional way of strengthening budgetary discipline, strengthening the existing SGP.[7]
An additional advantage is the fact that the costs of 'bad policy' (such as a government deficit rising too rapidly) are directly though gradually borne, in the form of a rising mark-up, by 'the culprit' itself, while the other countries are on the contrary confronted with a lower or even negative interest margin. It would for once and for all mean the end of the 'free rider's paradise', without any chance of it to return. The marginal costs of bad economic policies are therefore higher for the individual member states than they have been in the past few years; conversely, the advantages of 'good policy' are correspondingly great. Passing the buck is therefore not – or almost not – possible.

At the same time, intelligent selection of parameters permits relatively differentiated approaches to be adopted for countries. This means, for instance, that a country with a government deficit that is rising too quickly but with relatively low government debt is punished less severely than a country that scores poorly on both parameters.

An enormous advantage is that mark-ups and mark-downs are determined on the basis of objective measures and are not sensitive to acute reversals of sentiment. The new fund on the one hand restores the disciplinary effect that the financial markets should - but in practice often do not - exert in normal times, while at the same time protecting countries against acute reversals in sentiment. The more systematic discipline of the EMU fund in this model replaces the more capricious discipline from the financial markets.

Structure of EMU Fund



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[7] See Boonstra (2005).

The EMU fund will soon by far be the most important issuer of Eurobonds, dwarfing all the national public bond markets and over time overshadowing the market for US Treasuries. Given the total volume of the funds to be raised annually by the EMU fund in the market this fund will be able to establish itself as benchmark across the entire maturity spectrum of the yield curve. Its depth and size will make the market for loans of the EMU fund highly attractive to large investors; in addition it will be much better able than the German Bund to support a large derivatives market, without the risk of illiquidity in times of strain. [8] The emission volume of the new fund will soon exceed that of the U.S. market for Treasuries and substantially strengthen the 'competitive position' of the euro versus the dollar. The dollar will no longer have a monopoly as the ultimate safe haven.

Drawbacks of the EMU fund approach

This approach also involves a number of drawbacks. The most important of these come down to the problems in objectively setting the mark-ups and mark-downs used by the EMU fund in its lending to the various national governments. A second drawback relates to the fact that this model at first sight, in a certain sense, appears to undermine the 'no bailout' clause of the Maastricht Treaty.

Computing the margin

For the first issue, a simple straightforward formula such as the following will suffice:

$$R(i) = \alpha\,[O(i) - O(m)] + \beta\,[S(i) - S(m)]$$

Where:

- R(i) = the margin payable by country i over the funding costs of the EMU fund
- O(i) = the government deficit of country i, as a % of GDP
- S (i) = the government debt of country i, as a % of GDP
- The variables O(m) and S(m) represent the EMU average for government deficit and government debt
- The parameters α and β are coefficients, used to determine the weight of the relative performance on government deficit and government debt respectively in setting the mark-up.

Obviously, variables can be added to this comparison, such as the level of public investment or the share of the public sector in the economy. For sake of transparency, however, it would be a good thing to keep the formula as simple as possible. Moreover, the attraction of the variables selected here is that they do justice to both current developments (relative performance on government deficit) and the legacy of the past (existing government debt). It could be

[8] This gives rise to a question relating to existing government debt. Should this also be taken on by the EMU fund or not? This is one of the points that need to be worked out in greater detail, but an initial thought is to let the existing government loans continue and replace them with EMU fund loans after repayment (possibly ahead of schedule). This will lead to a transition phase of a few years, in which on the one hand the EMU fund becomes the benchmark, while on the other the secondary market (the primary market no longer exists) for existing government loans will dry up.

considered to include future developments in the deficit in the spread as well, for instance on the basis of the forecasts of the European Commission for government deficit and government debt. However, this brings the danger of political discussions about the degree of accurateness of these forecasts. Therefore, it seems best to stick to as 'hard' figures as possible.

The coefficients α and β will have to be set in advance, subject to the enabling condition that the sum of positive and negative margins must approximately equal zero. Setting these coefficients inevitably involves an element of arbitrary judgement, in which political considerations will also play a part. The key questions are, naturally, how sensitive one wishes to make the system for relative performance of the participating countries and which relative weight should be put on past performance (public debt ratio) and current performance (public deficit ratio).

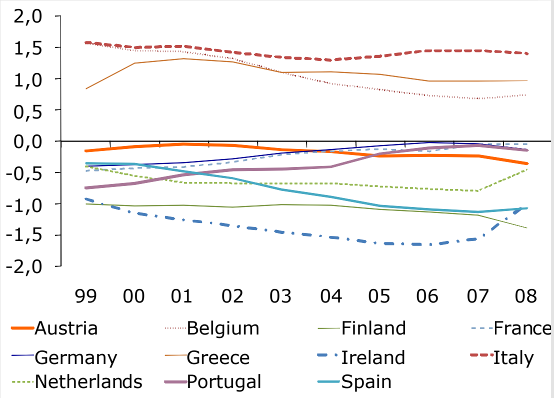
But the seriousness of this element of judgment in setting the required parameters must not be exaggerated. For once they have been set, the parameters are not more or less arbitrary than the current ceilings deriving from the Maastricht Treaty and the Stability and Growth Pact. The good news is that once the parameters have been set the rest is a matter of straightforward calculation. The system is completely transparent.

Two sample calculations

Two scenarios are worked out in this box. As stated earlier, setting the parameters α and β is a comparatively arbitrary process. An important question in doing so is of course how sensitive one wants the spread to be calculated to be to developments in government debt or the budget deficit. Government debt is important as the best indicator of the financial status of the government of a country. The deficit performance obviously best reflects the current state of affairs. In addition, this parameter can be adjusted fairly quickly, offering rapid rewards for good policy. Driving down public debt that has risen too far is by its very nature a slower process that will take several years. Accordingly, setting the parameters involves considering both the relative ratio between the two parameters, and their level: how far does one want the maximum spread to rise.

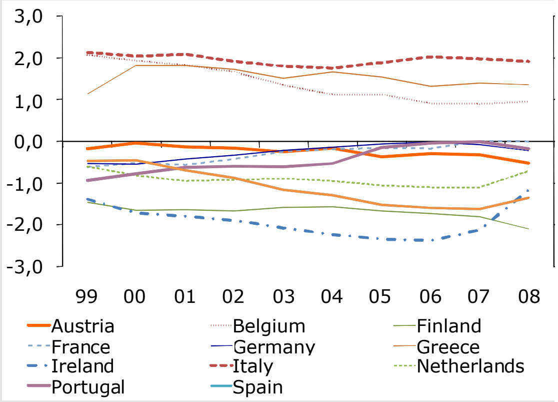
The charts below illustrate two scenarios by way of examples. In the first scenario the α is set at 0.0075 and the β at 0.0375. In the second scenario both parameters are set at 0.05.
Setting the parameters α and β will therefore also to a large extent be a political process. This process has to be non-recurrent and take place at the inception of the fund. After initial setting, computing the spread is a straightforward process of calculation. Again, this is an improvement over the current situation in which every breach of the European budget agreements leads to new negotiations.

Chart 1: Scenario 1



Source: Own calculations

Chart 2: Scenario 2



Source: Own calculations

Member states with payment problems

Even if government deficits can in future only be funded by the EMU fund, a member state can in theory run into problems servicing its public debt. But the situation under the EMU-fund would be fundamentally different than in the situation of today. If a country were to default today on servicing its government debt, it has to negotiate with numerous creditors and investors. However, any default on the part of a government of an EMU member state in a situation of central funding of government deficits leads to a bilateral problem with the EMU fund. The EMU fund will experience an acute deterioration of the quality of part of its assets and will therefore have to enter into negotiation with the country concerned on how the latter will meet its obligations again.

The EMU fund will enter these negotiations from a position of strength, since a country that is in default in meeting its obligations in respect of the EMU fund will at that time have no alternative access any more to other financial funds. It will no longer be able to turn to the capital markets with a new government loan: after all, a bankrupt country is the pariah of the international financial world. In such a situation the EMU fund will be able, analogous to the ability of the IMF to impose conditions on its members applying for financial support, to impose very strict and enforceable terms.

In practice things will not easily go that far. Firstly, the mark-up charged by the EMU fund to member states performing poorly will already rise gradually over time. Governments will therefore already be confronted in an early stage with the consequences of their behaviour and the EMU Fund will see warning lights flashing a long time before things will run out of hand.

A sudden deterioration of the market perception that would cause an acute liquidity shortage for a country within a very short timeframe is by definition not an issue in the proposed model. Countries will always have access to finance of their new public deficits or refinancing needs. As soon as the deficit or debt ceilings laid down in the European treaties come into view, the EMU fund can attach conditions to its lending, comparable to the ability of the IMF to do so. This point can be readily further refined.

However, the rather ineffective sanctions from the SGP must be replaced with political, more effective sanctions. [9] Evidently, budget criteria imposed by the fund must be suitably far removed from the point at which a country is at risk of payment difficulties.

Simple introduction, based on voluntarism

In technical terms, setting up the EMU fund is easy. But the entire construction critically depends on the political willingness to accept the rules for the EMU fund. This means that national autonomy concerning the mode of deficit funding is ceded to the community level. It also means accepting the fact that relatively poor performance will be penalised in the form of an interest rate mark-up, whereas good performance will be rewarded with an interest rate reduction.

The beauty of the present proposal is, however, that it does not require waiting until the most reluctant country is on board as well. If only several large countries with the highest credit rating, including Germany, France and the Netherlands, decide to fund their government debt centrally via a common agency in the future, the new fund could be a reality very quickly. [10]

Participation should be organized on a voluntary basis, no country should be forced to participate against its will. However, as the advantages of the common funding in the form of lower funding costs would be quickly evident, the remaining countries would soon want to join. In the process, the strong countries can require newcomers to accept the system of mark-ups and mark-downs, depending on the quality of their public finances. These are likely to agree swiftly because even for the weaker countries the advantages of the lower average funding costs (owing to the greater liquidity) and the greater stability will comfortably outweigh the mark-up they will be asked to pay. On balance, it may be expected that ultimately all countries will face lower funding costs.

Practical issues

As with most innovative schemes that looks simple at first sight, the devil is in the details. A number of practical issues need to be tackled. In this paragraph, a number of issues will be briefly discussed.

[9] For a detailed proposal see Boonstra (2005).

[10] Note, however, that it is also a possibility that a group of countries with relatively weak public finances decide to pool the funding of their fiscal deficits and start the EMU fund. This would bring them the opportunity of benefiting from the liquidity premium. Moreover, it shields individual countries from sudden changes in market sentiment. This approach would result into minor changes in the design of the EMU-fund. Especially the question how to deal with the entry of financially stronger countries should be solved.

Size versus flexibility

Will the EMU fund be flexible enough to serve the participation countries optimally? On the one hand, it need to issue huge benchmark bonds to make optimal use of its size and create maximum liquidity of its bonds. On the other hand, the countries would prefer to have optimal flexibility in the financing operations and have the freedom of early redemption of outstanding debt.
However, this problem should not be exaggerated. This is the traditional business of consolidated banking groups, like the centrally organized cooperative and savings banking sector where the central organisation deal with these issues on a daily basis. The larger the EMU-Fund, the easier it will be to serve its 'clients' optimally.

Spread mechanism and the size of the borrowings

A second issue deals with the spread itself. In the examples the spreads are calculated with a fixed formula. This has the large advantage of simplicity and transparency, but it can lead to profits or losses of the EMU Fund, due to the difference in size of the participating countries. This can be seen from a simple example. Let's for the sake of the argument assume that all countries have the same public debt and deficit ratios, with only two exceptions. Large Germany is in this example the only country doing better than average and small Slovenia is doing worse. Germany deserves a negative spread which, given the size of the country, adds up to a substantial amount. Slovenia, which will pay a positive spread, will pay a much smaller sum to the EMU Fund because it is a small country. As a result, The EMU Fund will make a loss, which is highly undesirable.[11]

This problem can be dealt with in several ways. The first and theoretically most beautiful approach is of course developing a formula that calculate the spread under the precondition that the amounts of negative spreads and positive spreads should add up to zero. However conceptually beautiful this may be, it would result in a continuous process of difficult and opaque calculations that would bring flexible spreads that changes from year to year, every time reopening the debate about the technique of calculating them.

A second, much simpler and more robust formula would to start with the assumption that France and Germany taken together would more or less determine the EMU average and thus, by definition, will never have a positive or negative spread. By participating in the EMU Fund they simply cash in the benefits from improved liquidity of the bond issues of the fund. A second assumption is that the fund only calculates positive spreads for the countries that on the public deficit and debt criteria perform worse than Germany and France. For countries that perform better the spread is set at zero, they also just benefit from the better liquidity.

[11] Note that it is of course also possible that in other potentially possible scenarios the EMU Fund will turn out a profit.

In this construction, the EMU Fund will always make profit, which can for example be used for financing (part of the) EU budget or be distributed to all countries that participate in the EMU Fund.

Complementary partial plans

The EMU Fund is ambitious in its design. Although it may start with only a relatively small number of countries, it ultimately aims at participation of one hundred percent of the member states. One could also imagine however, that the countries that today are paying the highest spread on their bond issues join forces and start to fund their public deficits together via a central agency. This would bring them several advantages as well, such as lower funding costs and integrating their economies more deeply into EMU. Once participating in central funding, no individual country can be targeted by the financial markets as potential 'candidate' for leaving the eurozone. [12]

Beneficial for all participants

It is important to realise that the introduction of central funding of public deficits in the euro area is beneficial for all participating countries. For the countries that are perceived by the markets as relatively weak the benefits are clear. In this construction they are sheltered by the EMU fund from the swings in sentiment on the financial markets. Even in the most turbulent scenarios, markets will never be able to force countries out of the EMU by charging them extreme interest rates or even deny them access to finance. Moreover, even when they are charged a spread, their average funding costs may be expected to be lower and, once they improve their economic policies, the reward in the shape of lower interest rates will be immediately. The price they pay, of course, is that as long as their policies are of poorer than average quality, they will have to pay a higher interest rate. They can influence this spread, however, by improving their public finances.

For the stronger countries the most important benefit is the consolidation of the euro for the future and cheaper funding costs, due to the liquidity effect. Also the fact that the EMU-fund may charge a spread to countries that perform relatively poor with their public finances is an advantage. Recent history has taught us that financial markets either are too lax, giving countries with weak public finances a free ride for years, or to violent, adding to the euro's strains. The discipline from the EMU-fund is more gradual and increasing one public finances deteriorate.

Concluding remarks

The basic idea of the proposal presented here is not entirely new.[13] The first time this proposal was put forward, in 1991, the transfer it required of

[12] This idea was contributed by Jean-Jacques Rey

[13] See Boonstra (1991), (2005). Similar thoughts were ventilated by de Silguy (1999). Recently, Nauschnigg (2009), also suggested the creation of a EU wide bond market.

budgetary sovereignty from a national to a community level proved to be a step too far.
Since then the euro has been introduced, the SGP has been in use for years and the single currency is a major success in many respects. Nonetheless, it is necessary to further strengthen the institutional framework of the single currency. This can be achieved very quickly. As soon as a core group of important EMU member states with an AAA rating, such as Germany, France and the Netherlands, decide to fund their deficits via a common agency in future, possibly with mutual guarantees, the EMU will more or less already have crossed the Rubicon. For if the most important countries in the eurozone adopt central funding of their government deficits they will not only make the euro a great deal stronger, but also send out an unambiguous signal that the introduction of the euro was an irreversible process and that the European currency is here to stay. Note that this approach more or less reflects the way France and Germany established the exchange rate mechanism of the European Monetary System in 1979. What started as a relatively modest step by the major countries has culminated in the introduction of the euro twenty years later.

The non-adopters may be expected to want to join soon in view of the evident advantages of common funding and are expected to be willing to accept additional conditions to that end. This is because if they remain outside the common funding system they run the risk of being identified as potential drop-outs.

Once they have joined the EMU fund the financial destiny of the participants will be irreversibly conjoined and the United States of Europe will be a reality in financial terms at least. No one would ever speculate again on the disintegration of the eurozone, just as the substantial economic differences within the U.S. never lead to speculation on the disintegration of the U.S. dollar.

By consolidating the euro for the future the European Union is also positioning itself as a financial superpower for the 21st century. By contrast, a disintegration of the eurozone would gradually condemn Europe to a marginal role in the global playing field. As a single block the EU is the world's largest economy and therefore a big player, whereas individually the member states, with the possible exception of Germany, would soon not have any part to play. However small the chances of a disintegration of the euro may be, the consequences would be so severe that it has to be avoided at any cost. The euro must accordingly be cherished, strengthened and made future-proof.

In sum, central funding of budget deficits within the EMU via a new EMU fund would be a logical next step on the path of European integration.

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Text as at December 31st, 2009

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Part II: Blue bonds: creating a pan-European common government debt

Presentation made at ELEC Monetary Commission, Brussels - 11 December 2009

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At this moment government debt in the euro zone is highly fragmented. In the US there is a unified US treasury bond public market of US$8,000bn, that provides liquidity and safety to world investors In the euro area (EA), the market of public debt amounts to €8,000bn, but with 16 government bond markets. This fragmentation means a lack of liquidity for all, except Germany, France and Italy. This has not reinforced solvability, rather the opposite (cf. Greece). The Stability and Growth Pact (SGP) is not binding, hence risks for the EA if there is a default.

This can be solved by creating a common euro government bond (EGB) market. Merging debts would provide higher liquidity for non German countries and lower (German) benchmark rates because of attraction to Asian investors. The advantage of this proposal is that it combines liquidity with market signals about solvency.

If a common European bond market is to succeed, there are several requirements to be fulfilled:

- Stabilize or reduce rates for Germany
- Increase liquidity to reduce non-German rates
- Agreement of Germany
- Provide proper incentives for Highly Indebted Countries (HICs) to reduce debt
- Allow Germany to quit the scheme if necessary
- Allow Germany to expel diplomatically HICs which would violate the Club's rules
- Simple and easy to understand for markets and public
- Have national treasuries (and not the EC) in charge
- Do not be in the hands of rating agencies

Blue and red debt

Our proposal is to make a distinction between senior (Blue) and junior (Red) debt in each country. Common EGB debt would be senior in each country, versus junior debt. Senior debt is the first 40% of GDP (could be up to 60% of GDP) of the public debt. There is joint and several responsibility on Blue senior debt. In this way, a unified Blue debt market is created.

A tight budget rule for every country would force HICs to enforce credible and strict fiscal policy. Decision rules in the Club are left to the most credible large countries (de facto Germany) after recommendations from a committee of wise persons. Deviant countries would be expelled from the mechanism by not being allowed to issue new Blue debt.

One could imagine that the scheme starts officially on D-Day. This gives rise to the following kinds of debt:

- **Blue debt**: government debt issued, after D-Day, in common by governments, with European joint and several guarantees. Blue debt is senior, with European guarantee.
- **Red debt**: government debt issued after D-Day and junior to senior debt. Red debt is junior to Blue debt and Grey debt. Red debt is national, without European guarantee.
- **Grey debt**: government debt issued before D-Day. Grey debt is senior and is only national (i.e. no European guarantee).
- **Rest of (Maastricht) public debt** would be made of government agencies (KfW, CADES, RFF, …) or local governments' debt. All those agency debt issued after the scheme starts will be junior.
- Guarantees (i.e. with banks) and off-balance sheet debts issued after D-Day are junior.

Each participating country would have *de jure* to split its government debt into two: Senior / Junior. Junior debt would remain as current EGBs, or Länderdebt, agencies debt, local government debt, etc. Senior (Blue) debt would constitute (up to) the first 40% (or 60%) of GDP. This could be lower than this level for lower rated countries.

Why 40%? Because it is the size of the German government bond (and bill) market (€1Trn) (until 2008). Why 60%? This is the Maastricht maximum level. But the current crisis will push public debt to 90%/100% of GDP at the end of the current crisis (by 2013) for Germany, France,… This would have to be agreed of course by Germany.

Joint and several responsibility

The responsibility has to be joint and several so that all members are responsible for the others debt. This allows safe haven status and huge liquidity, as there is no doubt for investors about integrity and quality of bonds. With sole "several responsibility" (like Pfandbriefe for Länder), investors would doubt of the quality of the debt. Furthermore, common EGB might not be AAA, and only AAA countries would be too small a number.

But joint and several status must be backed by further fiscal discipline (requisite for Germany). Without strict and enforceable budget rule, Germany will not back the scheme.

Countries joining must show they have a credible strategy to bring their debt level below 60% in a reasonable time. This can be done through the adoption of credible budget rules (like Germany 2009), or budget committees *à la Wyplosz.*

Guarantees should be issued by the each parliament, each year. That is how Germany (and France) holds the key: the German parliament would have to vote each year for guarantees to cover the rest of the senior debt in the scheme.

Who could join?

Any country can join that can find a piece of its public debt that can be senior and AAA and that is accepted by others. Provided of course that the government can credibly commit to reducing its public debt.

Cheatings on deficits and public debt disqualifies Greece form joining the Blue bond market. But Spain, Italy, Portugal, Portugal, … (non-AAA) could join. Other EU countries, non member of the euro, may be allowed to issue in Blue debt. But all these cases need unambiguous and clear legal division of their public debt: senior versus junior, plus clear adherence to the Club's rules.

The Club is to decide on who is allowed to issue in Blue debt, for how much of its GDP and whether the country's debt path is sustainable and compliant with the rule of the Club. An independent committee of wise persons would analyze each country's debt path and fiscal policy and would propose an allocation of Blue debt for each country for the next year.

Large and credible countries (i.e. Germany) would have de facto the decision, in order to avoid being hostages of highly indebted countries?

A new Treaty

Countries willing to participate would sign a Treaty, containing the senior / junior pledge plus joint and several responsibility and adherence to the Club's rule. If a country does not ratify, it stays out the Blue debt market. The question remains open whether it should be an EU Treaty or a simple Treaty.

The members could be all EU countries in the EUR or willing to join (except for Greece because of cheats on data). Some weak countries could be allocated less than 40% (or 60%) of GDP in Blue bonds. The best case would be EA-15, with all countries with a budget rule like in Germany. In case Germany refuses and wants to keep the bund, one could think of a scheme with EA-15 minus Germany, France, Italy, or of a non German scheme (EA-15 minus Germany).

Punishments

Deviant countries that would pursue an unsustainable debt policy would see their debt allocations either reduced or stopped. In 5 to 6 years a deviant country would see its Blue debt almost disappear. Deviant country would have to issue only red debt, most likely with wide spreads. Unlike with the SGP, countries will be unable to cheat for long. The Blue scheme is binding. As soon as it is obvious that debt/GDP is not in line with Club rules, issuance of Blue debt by the deviant country is stopped.

A country that is not satisfied (e.g. Germany) could (or threaten to) quit the Club in 5-6 years (average debt maturity) without disrupting the common EGB market, just by not issuing new common EGB debt. A country violating the Club's rules would be expelled smoothly: it would be forbidden to issue in the common EGB, until back credibly into rules. For a HIC, violating Club's rules would be very costly, very fast, as spreads on the HIC debt would jump and would immediately apply to 1/5th or 1/6th of its total debt.

Advantages

The gain for Germany would be lower rates because of larger role of Blue debt in world markets (attract Asian investors). Blue debt benefits from part of the privilege now enjoyed only by US. It forces fiscal discipline in the rest of the eurozone. The scheme enables to keep the euro zone together. It singles out quickly countries with an explosive debt path and allows Central and Eastern European countries, members or not of the eurozone, to have access to a large "cheap" debt pool. The scheme reinforces EU integration and avoids EA explosion. Finally, Germany has an opt-out option which reinforces its hand.

The exact gains are difficult to calculate. Before the crisis, the benefit of the US T-Bond market could be seen through swaps spreads at 60/80bps in US, while at 20/30 in Europe. The difference in swaps spreads could be ascribed to the larger liquidity in the US T-Bond market. This means a possible gain of 40 or 50 bps for Germany. But more research is to be done.

For other countries, the scheme eliminates liquidity spreads on their debts versus Germany on the Blue debt. This is very interesting for small virtuous countries (Benelux, Finland, Slovakia, Slovenia, Malta, Cyprus). Interest rates on red debt will act as a signal and as a deterrent on loose fiscal policies and will force reluctant governments to fiscal discipline. The Blue bond scheme is a market alternative to the SGP.

Of course, this scheme does not erase or conceal default risks. There would be a zero spread on the common EGB debt, but the default risk is shifted onto the junior debt. It would strengthen markets judgment on HICs deficits and debt path.

In the transition period, it is legally impossible to demote the seniority of the stock of outstanding bonds. Hence all EGB issued *so far* are senior. Exchange through forced redomination is impossible, since it would be considered as default.

A possible solution is to apply the senior-Blue / junior-Red debt criteria only to fresh debt and propose voluntary exchange to holders of old debt (which will give liquidity to the Blue and Red bond markets).

Another question is how to deal with countries with senior debt above the 40% level. Either they would have to issue sufficient amounts of junior debt before their senior debt equals 40% of GDP. Or we could contemplate that for the first years, countries would have 3 types of debt:
Grey (old debt from before start of the mechanism: Senior, but national); Blue (new Senior debt: Senior, but with EA joint and several responsibility) and Red (new Junior debt: Junior, National).

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Part III: "Joint issuance of euro-denominated government bonds"

by John BERRIGAN

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The emergence of a large and smoothly functioning euro-denominated government bond (EGB) market has been a notable success of Economic and Monetary Union (EMU). The EGB market now spans sixteen Member States and is substantially integrated, whether measured on the basis of price or quantity indicators. For much of the period since the launch of EMU in 1999, the pricing of EGBs has been highly convergent, particularly when compared to the pre-EMU era. In addition to this price convergence, the degree of market integration has been confirmed by a wide geographical dispersion in the holdings of EGBs both within and outside of the euro area.

Despite the degree of market integration achieved since the launch of EMU, the supply side of the market remains fragmented across sixteen different national issuers, having their own individual (and varying) credit ratings as well as different issuance calendars, techniques and procedures. This supply-side fragmentation means that EGBs are not fully fungible and has negative implications for the functioning of the EGB market, which is much less liquid than the market US Treasuries although comparable in size. Evidence suggests that the liquidity of the EGB cash market (measured as the ratio of turnover to outstanding stock) [1] is many times less than in the US Treasuries market. Indeed, liquidity in the EGB market appears to have migrated to the derivatives market, where the euro-denominated bund futures contract is among the most liquid instruments in global financial markets.

Within the EGB cash market, liquidity is concentrated among the larger national issuers, i.e. Germany, Italy and France. Smaller issuers have experienced considerable difficulty in managing liquidity in their issuance, while sharing a market with more liquid and near-substitute competitor instruments. Such problems with liquidity management were anticipated at the launch of EMU, when specific trading arrangements were put in place on EuroMTS - the main electronic trading platform for EGBs - obliging primary dealers to provide continuous two-way quotes. These trading arrangements guaranteed liquidity for smaller EGB issuers (with sufficient volume to participate on the platform), but limited the profitability of primary dealing so that the two-way quoting obligation has been gradually removed. Smaller issuers have also sought to enhance liquidity by adapting their issuance techniques (e.g. greater use of syndication instead of auctions) and by concentrating their issuance in a restricted number of maturities. Nevertheless, low levels of liquidity have

[1] See Persaud Avanish D., (2006), "Improving efficiency in the European government bond market"

remained a constraint for smaller issuers and, by extension, for the efficient functioning of the EGB market as a whole.

Opportunity cost

Reduced liquidity in a cash bond market has a significant opportunity cost. As argued by the IMF,

> *"partly because of their unique characteristics, especially their minimal credit risk, government securities and the deep, liquid markets in which they are traded have come to play important, if not critical, roles in facilitating aspects of private finance. In particular, they have facilitated the pricing and management of financial risks associated with private financial contracts."* [2]

Such opportunity costs may be even greater in the more specific context of EMU. Liquidity is a key factor in maximising the positive externalities of an integrated EGB bond market to the broader EU financial system by enhancing opportunities for risk management, improving reference pricing, stimulating innovation etc. At a macroeconomic level, a liquid euro-denominated government bond market can help in the conduct of decentralised fiscal policies (reduced cost via a lower liquidity premium) and the single monetary policy (more uniform transmission of monetary policy). Moreover, access to a large and liquid EGB market enhances the role of the euro as an international currency. To the extent that liquidity in the EGB market is constrained, all of these potential benefits are mitigated.

Measures to enhance liquidity in the EGB market have been the subject of analysis almost since the launch of EMU. In 2000, the Giovannini Group [3] prepared a short report on the topic and identified four possible options for enhancing EGB market liquidity. These were (a) intensified co-ordination of issuance practices and procedures among national issuers in the euro area; (b) joint and several issuance among some or all euro-area national issuers; (c) joint issuance among some or all euro-area national issuers; and (d) common issuance via a centralised agency on behalf of all euro-area national issuers. The pros and cons of these four options were explored, focusing on economic, legal and political aspects. As there were significant problems with all options, the Group concluded that it was too early in the life of EMU to make radical changes in issuance arrangements. The euro-area Member States took a similar view and opted for relatively modest improvements in the co-ordination of issuance practices and procedures as the most likely avenue for progress.

Co-ordination among national issuers of EGBs has remained modest in the ten years since the publication of the Giovannini Group report. In fact, it might be argued that national issuers have chosen to pursue a more competition-based approach to issuance, relying on differentiation in there issuance as a means

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2 See IMF Global Financial Stability Report, August 2001

3 A group of capital market experts, under the chairmanship of Alberto Giovannini, which has provided the Commission with technical and policy advice.

to attract investment from an increasingly common investor base. Against this background, the topic of enhancing liquidity in the EGB market has resurfaced on numerous occasions within official circles, notably as the euro area has expanded to include new smaller issuers and the problem of managing liquidity within the EGB market has become more widespread. Furthermore, the gradual emergence of the euro as the second international currency after the US dollar has focused the attention of market analysts and academics on the absence of a euro-denominated risk-free asset to match the US Treasury. In the past year, interest in the topic has become even more pronounced, as evidenced by the other contributions to this volume.

While the economic arguments in favour of joint issuance as a means of enhancing EGB market liquidity are unchanged, the proposals for joint issuance have become increasingly sophisticated. More recent proposals have involved the use of modern financing techniques such as special purpose vehicles, credit tranching etc, but there is still no consensus among national issuers on the question of joint issuance. In addition to a wide range of legal and technical obstacles that would need to be overcome to allow joint issuance, the larger issuers still regard the creation of a fully integrated EGB market as a "zero-sum game". Accordingly, these larger issuers perceive any gains in terms of liquidity as being more than offset by a potential dilution of their credit quality in any joint issuance with lower-graded issuers.

The no-bail out clause

Perhaps the most fundamental obstacle to joint issuance is the so-called no-bail out clause in Article 125 of the EU Treaty. Article 25 of the Treaty states that:

> *"The Union shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project. A Member State shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of another Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project.*
>
> *The Council, on a proposal from the Commission and after consultation with the European Parliament, may, as required, specify definitions for the application of the prohibitions referred to in Articles 101 and 102 and in this Article."*

If read in an unjustifiably narrow sense, this Article could seem to prohibit joint issuance of EGBs because it would imply the possible transfer of debt obligations from the government of one euro-area Member State to another. While the primary objective of joint issuance would be to create liquidity rather than transfer debt obligations between Member States, it can be argued that a transfer of obligations would be an inevitable by-product of joint issuance in the event that a participating Member State were to default on its debt repayments. Such concerns, which are rooted in a fear of creating moral hazard for governments in managing their public finances, has been heightened by budgetary developments since the onset of the global financial crisis.

Article 125 reflects the unique nature of the euro area, with a single monetary policy but a decentralised budgetary framework. The prohibition on the transfer on debt obligations between the governments of euro-area Member States is designed to provide an incentive for sound budgetary policy by removing the option of a bail out for any government experiencing funding constraints. However, the absence of a bail out in extremis is not sufficient to discipline national budgetary policies on a continuous and consistent basis, because it is a relevant constraint only when imbalances have already become so large as to be unsustainable. For this reason, Article 104 - as elaborated by the Stability and Growth Pact - provides a framework of discipline for the ongoing conduct of budgetary policies. Article 104 was designed to prevent and correct budgetary imbalances as they accumulate and well before any risk of default and possible bail out becomes relevant. Under the combined influence of Articles 104 and 125, the budgetary performance of all euro-area Member States improved in the first decade of EMU, although doubts about the willingness of Member States to allow a government debt default within the euro area have persisted in financial markets.

Two different markets

In addressing the obstacles presented by the specific budgetary framework in EMU, proponents of joint issuance have developed approaches that combine the benefits of enhanced liquidity with budgetary discipline. A common theme in such approaches is to divide the EGB market between joint issuance and issuance remaining at the national level (i.e. creating a market structure analogous to the US government bond market with federal and state levels). The national portions of EGB issuance would remain the sole responsibility of the issuing Member States and yields on this portion would reflect the relative budgetary performance of the respective Member State compared to the euro area. As the national portion would be relative small, the prospect of a default on this portion would not be catastrophic and so more credible to investors. In consequence, these yields would be highly sensitive to divergences in relative budgetary performance and so would be a powerful mechanism for market signalling. This approach, which combines the benefits of market liquidity with enhanced budgetary discipline, would clearly conform to the economic spirit of Article 125.

While the economic rationale of Article 125 can be addressed by tailored approaches to joint issuance focusing on preserving (possibly even enhancing) budgetary discipline, the political dimension is more difficult to address. The concept of national responsibility for budgetary policy is a basic characteristic of EMU and joint issuance could be perceived as fundamentally altering the EMU framework. Accordingly, joint issuance is a political taboo for many irrespective of any economic arguments that can be made.

In conclusion, it is clear that EMU has allowed the creation of a substantially integrated euro-denominated government bond market. However, integration is more advanced on the demand side than on the supply side, where issuance remains fragmented across 16 national issuers. Joint issuance by these issuers would help to address the relative illiquidity of the euro-denominated government bond market relative to the comparably sized market for US Treasuries. The budgetary framework in EMU – as composed of Articles 104 and 125 of the Treaty - is the main stumbling block to joint issuance, implying a prohibition on the transfer of obligations among Member States that is predicated on both economic and political grounds. While reasonable economic arguments can be made in favour of joint issuance, which take account of these Articles, political obstacles are likely to remain the major hurdle to be overcome in promoting joint issuance.

Post-script

Given the scale of the ongoing global economic and financial crisis, it is not surprising that the functioning of the euro-denominated government bond market has been impacted. The impact of the crisis is evident in two main respects. First, increased investor risk aversion has resulted in a flight-to-quality into government bonds and has resulted in a generalised decline in yields. Second, the significant budgetary implications of the crisis have encouraged greater investor discrimination among issuers on the basis of the relative condition of their public finances. In consequence, the overall decline in yields on euro-area government bonds has been accompanied by a much greater divergence in their yields. The widening in yield spreads relative to for euro-area issuers of government bonds mainly reflects differential credit risk, as public finances have been impacted to a varying extent among the euro area Member States. In these circumstances, the economic rationale for joint issuance has been undermined while political acceptance of pooling the credit quality of various EGB issuers has become even less likely.

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Part IV: The Creation of a Common European Government Bond Arguments Against and Alternatives

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I. Introduction

The idea to create a common government bond market for the euro area was already under discussion in the run-up to the introduction of the euro in the second half of the 1990s. Then, some market participants deemed a common government bond a cornerstone of bond market integration under the roof of a single currency. A key aim was to give the euro area the same government bond instruments as the US Treasury in order to promote the euro's international role as an investment and reserve currency and to strengthen the competitiveness of European financial markets in comparison to the US. In particular, a powerful central government bond issuer and liquid instruments in nearly all segments of the yield curve were lacking in Europe.

An important contribution to the intensive debate on the integration of government bond markets was the report of the Giovannini Group (2000) on the "coordinated public debt issuance in the euro area". The gist of the report was that "the co-ordination involving a joint or single debt instrument was not regarded as a practical option for the euro area as a whole." A main argument against was that a common European government bond would require a common guarantee scheme, which is not compatible with the no-bail-out clause of the Maastricht Treaty. However, the Group also acknowledged that the topic should remain under review in the wake of the structural change in euro financial markets in the years to come. The Report points out the possible benefits for smaller member states with limited issuing capacity and liquidity as a common bond could reduce the premium they have to pay, compared with the yield of the benchmark bonds of Germany and – in a few segments – France.

II. Good reasons for reconsidering the issue

Although the euro has triggered substantial progress in financial market integration in Europe since 1999 under the aegis of the Financial Services Action Plan (FASP) there are still several good arguments in favour of a fresh debate on the prospects of government bond market integration in the euro area. Thus, it is not surprising that the financial crisis that started in August

2007 and the substantial widening of spreads have rekindled the debate on the creation of a common government bond instrument. [1]

In 2010, the EU does not have a central government bond issuer yet – with the power of the US Treasury – and none is in the offing despite the recent ratification of the Lisbon Treaty, which is to strengthen the EU's political ability to decide and act in a globalised world. Liquidity still varies considerably between national government bond markets. Government debt instruments of Germany and France with a triple A rating [2] are liquid but lag behind the huge US market. By contrast, most other national bond markets lack liquidity. Nevertheless, international institutional investors seem to be content with the liquidity of the German and French government bond markets. For instance, a survey among central banks [3] concluded that euro money and debt markets have reached the same quality as dollar markets as far as the liquidity and the availability of instruments are concerned.

However, liquidity problems of small and medium-sized EMU countries have even intensified by EMU enlargement by four small countries to sixteen member states since 2007. Government bond markets of potential EMU candidates are also relatively small with the prominent exception of the UK. However, there is hardly any political will in the UK to join EMU in the years to come.

Furthermore, any increase in liquidity in the euro area's government bond markets could boost the euro's role as an international investment and reserve currency. So far, the dollar has had a clear lead as international currency. It will remain the global currency No. 1 in the years to come. Yet, the euro has gained ground since its launch in 1999. It will remain a challenge to the dollar given the euro area's economic potential as well as the size and integration of financial markets.

The greenback's share in the stock of international debt securities fell to about 45% by the end of 2008 while the euro's share rose from about 20 % in 1999 to 32% in 2008, being far ahead of the yen and pound sterling. [4] The euro has also become the reserve currency No. 2. Its share rose from 18% of global foreign exchange reserves in 1999 to 27.5 % in mid-2009 but it is still lagging far behind the dollar, at a share of almost 63% [5]. The greater attractiveness of euro bonds for international investors could reduce yields and borrowing costs for governments and private-sector issuers in the euro area. Such a benefit has accrued to dollar borrowers so far. The highly liquid US government bond

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[1] European Primary Dealers Association (2008), A Common European Government Bond, Discussion Paper, EPDA is an Affiliate of SIFMA (Securities Industry and Financial Market Association); Wim Boonstra (2009), Special: Make the euro stronger, Economic Research Department, Rabobank; Paul De Grauwe and Wim Moesen (2009), Gains for All: A Proposal for a Common Euro Bond, Intereconomics, May/June

[2] Besides Germany and France the following EMU countries had a triple A Fitch Rating in December 2009: Spain, The Netherlands, Austria, Finland and Luxembourg

[3] The survey was carried out between September and December 2004 among 65 asset managers of central banks. See Robert Pringle and Nick Carver (2005), Trends in reserve management – survey results, Central Banking Publications, London

[4] ECB (2009), Report on the international role of the euro

[5] IMF (2009), Currency Composition of Official Foreign Exchange Reserves (COFER)

market and the ensuing inflows of capital (including foreign exchange reserves) is estimated to have lowered the level of dollar interest rates by up to 1.5 percentage points. Therefore, the aim of the euro zone should be to get a share of this US privilege.

Another argument in favour of a common bond goes along the following line: the instrument would increase the liquidity and attractiveness of euro bond markets, thus triggering higher capital inflows and an increase in the euro exchange rate against the dollar. Such a consequence, however, could be a mixed blessing. In a period of a weak euro exchange rate – as in the years from 1999 to 2002 – a strengthening of the euro exchange rate could be welcome. However, a long phase of a relatively strong euro – e.g. rates between 1.30 and 1.60 USD/EUR in the years from 2007 to 2010 – could hit hard the price competitiveness of the euro area's export sector.

Finally, importantly cheaper budget financing is welcome as a common European government bond is assumed to stimulate liquidity and thus lower bond yields. The economic and financial crisis of 2008/2009 has even accentuated this argument by boosting borrowing requirements due to deficit spending and rescue packages for banks. The vast majority of EMU countries run excessive deficits well over the limit of 3% of GDP of the Maastricht Treaty in 2009, 2010 and beyond.

Non-triple-A-rated EMU governments have to shoulder a larger interest rate burden due to a sharp widening of government bond spreads especially after the collapse of the investment bank Lehman Brothers in September 2008. Investors pursued a policy of "flight to quality". Strikingly, the spreads of some EMU member states (such as Greece and Ireland) escalated much more than those of other countries (e.g. Italy, Spain and Portugal).The widening of spreads reflects a change in risk awareness. Thus, spreads are unlikely to return to the low level "before Lehman". A common bond could be a way out of the dilemma by eliminating spreads within EMU and offering higher liquidity for those EMU countries hit hard by the financial crisis.

III. The arguments against

Notwithstanding these arguments for reconsidering the creation of a common government bond, there are also several strong arguments against such a proposal.

First, liquidity has improved significantly anyway since 1999 due to rising issuing volumes, new instruments and the harmonisation of market conventions, not only in the field of government bonds but with regard to corporate and mortgage bonds.

The elimination of exchange-rate risks in the euro area has boosted the diversification of funds and reduced investors' home bias in the government bond market and beyond. There has been a greater diversity of innovative products, e.g. inflation-linked government bonds and more efficient futures and options markets for government bonds. Euro assets have been attractive without a common government bond.

Second, a common bond contradicts the no-bail-out clause. A common bond threatens to undermine fiscal discipline, which is a basic pillar of EMU beside price stability and an independent ECB. The no-bail-out clause is essential to strengthen national fiscal discipline as long as the EU budget is small and no political union with a large central budget is in the offing. The very small spreads between EMU government bonds until the Lehman collapse of September 2008 have reflected strong market scepticism as to whether governments would implement the no-bail-out clause given the close economic and financial ties within the euro area.

The financial crisis has changed the situation. The crucial question is, however, why should the introduction of a common bond mitigate the disciplinary effect of widening spreads within EMU? There are several important reasons for resuming fiscal discipline once the crisis is over, i.e. creating scope for stimuli in recession, covering the rising demographic costs, pursuing growth-friendly tax policies and supporting the monetary policy of the ECB. A common bond could stoke EMU governments' appetite to take up even more debt and erode fiscal discipline. Furthermore, there is the risk of getting lost in the "nice" technical details involved in the proposal to create an EMU guarantee fund for joint issues of all EMU governments. For instance, such a technical detail could be the idea of fixing a margin that member states would have to pay to an EMU guarantee fund in charge of issuing a common government bond.

A further crucial question is whether there should be a "completion" of the euro bond market by a common government bond scheme although no political will is discernable to create a political union. Fiscal discipline is also indispensable in light of widespread inflationary fears caused, inter alia, by soaring public debt in so many countries. The high gold price is only one important clue for such fears. Thus, EMU's essentials as a "stability union" should be taken seriously.

Third, substantial additional costs are likely for the triple-A-rated countries as a common government bond means a bundling of fiscal responsibility and burden sharing in the euro area. A common government bond must be associated with guarantees from triple-A-rated borrowers for non-triple-A borrowers regarding interest payments and/or redemption in order to place smoothly a common European government bond with institutional investors around the globe.

In the process of launching a common government bond, it is likely that the rating of several triple-A-rated EMU countries will deteriorate given their own high public borrowing requirement in the years to come and the fact that budget consolidation within Stability and Growth Pact (SGP) will only start in 2012 or even later. Thus, an EMU guarantee fund triggers higher interest payments for triple-A-rated EMU countries regarding both financing of their current budget deficits and refinancing of their maturing public debt. Therefore, the yield advantage assumed by the proponents of a liquid common bond could be easily "outweighed" by the disadvantage of higher interest rates for all new government bond issues.

In this context, some other problems might arise. For instance, a politically sensitive issue is that those countries guaranteeing the interest payments and redemptions of a common government bond might be tempted to interfere in the internal affairs for other partner countries according to the slogan “he who pays the piper calls the tune!” Furthermore, the additional interest-rate costs could carry weight. They are, however, hard to quantify. The latter fact disqualifies the theoretically brilliant proposal of Wolfgang Münchau [6] that the winners should compensate the losers. There is probably no reliable and quantifiable basis for a Pareto-like deal.

Fourth, a common European government bond implies a burden sharing among member states if an EMU state threatens to go bust. An EMU guarantee fund implies a moral hazard problem as non-triple-A-rated states could be tempted to neglect fiscal discipline relying on being bailed out anyway in case of severe turbulence. This risk has to be taken into account if the non-bail-out clause is undermined.

The answer to the question whether an EMU member state really can go bust seems to be simple: in theory yes, in practice no. Financial solidarity within EMU and the EU is in the national self-interest of nearly all other member states given the close economic and financial ties. In contrast to a company, a country, which announces to be bankrupt, will not disappear. However, a country in turbulence could cause severe systemic risk for monetary union as a whole, for instance in form of contagion risks for other EMU member countries with similar problems. Obviously, there are no explicit provisions in the Treaty to specify the support for an EMU member state.

An EMU country in severe fiscal turbulence may obtain financial support from the other member states. Yet, a bailout of a budgetary offender is only an option of last resort and financial support must be linked with strict conditionality. By contrast, EMU member states do not need financial support to correct disequilibrium in the balance of payments. [7] A common bond would therefore not be eligible for such a purpose.

Finally, a higher interest burden due to a common government bond implies the risk of increasing euro-scepticism when the taxpayers of triple-A-rated states will get such a message. In particular, this is likely to be true for Germany and France, which would have to bear the brunt of the higher interest burden. A further increase in euro-scepticism is, however, not

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6 Wolfgang Münchau (2009), ibid

7 The situation is different for the non-EMU member states of the EU as the problem cases of Hungary and Latvia, for example, in 2008 have shown. Joint rescue packages by IMF and EU with conditionality attached had been necessary using the financial resources and the technical assistance of the IMF. These two countries arranged the first IMF programme for EU member states since the IMF package for the UK in 1976/77. The readiness and ability of EU member states to support other member states in turbulence also depends on the overall economic situation. Financial solidarity could be considerable if one non-EMU member states of the EU or a few (small) countries are in trouble. It could, however, be limited if (nearly) all EMU countries are in a recession as in the economic and financial crisis 2008/2009.

desirable given the deteriorating image of "Europe" in public opinion polls throughout the EU and the ratification woes of the Lisbon Treaty.

IV. Are there alternative options to a common government bond?

Despite the substantial progress in the integration of the euro bond market since 1999 there is still room for enhancing market efficiency. In particular, two issues are essential: the lack of liquidity of small and medium-sized bond markets as well as the lack of liquidity of short-term instruments in the big EMU countries. There are repeated calls for improvements [8] and some interesting contributions to stimulate the debate [9]. In this context, four alternative options are worth mentioning. Three options concern the lack of liquidity of many government bond markets in virtually all maturities and the fourth option the lack of liquid short-term instruments in the big EMU countries.

1. Common bond issued by countries with the same rating

The lack of market liquidity of several national government bond markets reflects the special construction of EMU installing a single monetary policy but leaving the responsibility for fiscal policy at the national level. This construction will persist in the years to come. At the same time, EMU countries are likely to have different ratings. Thus, one option is to issue a common bond by those EMU countries, which have the same rating. In doing so, an EMU-wide guarantee scheme is not necessary.

Yet, an alliance of the strongest, i.e. of the triple-A-rated countries, is unlikely as there are no benefits for Germany and France discernable. Some countries might have an advantage in critical situations, e.g. Austria, witnessing a higher spread due to the strong involvement of Austrian banks in Eastern Europe severely hit by the financial crisis. An alliance of the double-A-rated countries[10] might generate the benefit of greater liquidity. Yet, heterogeneity in terms of both size and public debt ratios is a handicap. An alliance of the weakest, i.e. the A-rated countries[11], is too small to generate sufficient liquidity. In addition to these practical difficulties, it remains a moot question whether this option would comply with the bailout clause of the Treaty.

2. The model of German federal states

The second alternative could be a common government bond issued by a group of small and medium-sized EMU countries. Member states with different

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[8] European Commission (2008), EMU@10: successes and challenges after 10 years of Economic and Monetary Union, European Economy 2

[9] Wolfgang Münchau (2009), The benefits of a single European bond, FT, January 25.

[10] Italy, Belgium, Portugal, Ireland, Slovenia and Cyprus, Fitch rating in December 2009; according to the European Commission, the public debt to GDP ratio ranges from 61% in Ireland to 113% in Italy (end of 2009)

[11] They only comprise Malta and Slovakia, while Greece is a special case with a Fitch rating of BBB+

ratings could participate but Germany and France could not. Such a common government bond could be designed similar to the joint bond issued by several German federal states (Bundesländer) [12]. Individual federal states used to have low borrowing needs in absolute terms and had to tap the capital market rarely but had to invest or raise funds in the money market between their issuing dates. In order to avoid additional liquidity management costs, a number of federal states issued joint "Jumbo bonds" on a volunteer case-by-case basis. The benefits for investors consisted in a higher degree of liquidity and in the fact that the federal states involved are jointly and severally liable. Jumbo bonds have an average issue volume of about € 1.2 billion and are some of the largest bonds in the market for federal state bonds.

According to this model, joint issues of several small and medium-sized EMU states would allow a flexible coordination of issuing activities thereby bundling volumes and focusing on a few liquid maturities. EMU countries would have a vested interest to cooperate in joint bond issuing only with those member states, which have a good track record of fiscal policy. For a country, which is accepted to participate in a common bond arrangement this implies an incentive to pursue sound fiscal policies.

Nevertheless, the question of compliance with the no-bail-out clause of the Maastricht Treaty will arise once again. In Germany, a Treaty-like no-bail-out clause does not exist. Germany has – in contrast to the euro area – a central government, which is obliged to support – within limits – a budgetary offender among the federal states. The experience in Germany so far is that joint issues of government bonds of federal states on a case-by-case basis have not impaired fiscal discipline. It should be debated, whether the approach of a joint issue and joint liability of several small and medium-sized EMU member states could be designed in a way that would strengthen fiscal discipline.

This leads to one important conclusion. The no-bail-out clause of the Maastricht Treaty must not be, in general, an argument to kill new reform ideas from the very beginning. There has been an indispensable active role of fiscal policy in fighting and overcoming the economic and financial crisis in 2008/2009, which EU governments could not take adequately into account when they agreed on the design of the Treaty in the early 1990s. Therefore, there should be a debate about possible modifications of the no-bailout clause in the sense to strengthen fiscal discipline within the framework of the Stability and Growth Pact.

The pact reform 2005 was criticised to be a "paper tiger". It allows, however, a better economic interpretation and more flexibility in fiscal policy. Still, there is an important shortcoming in several member states, namely the lack of political will to consolidate the budget in good economic times within the framework of the preventive arm of the SGP. For instance, even Germany did not achieve a general government surplus in the period 2006/2008.

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[12] Deutsche Bundesbank (2008), The Market for Federal State Bonds, Monthly Report, June. Of the 16 federal states, eleven were involved in joint bond issues since 1996. The number of participating federal states varied over time. Interestingly, only seven small and medium-sized federal states issued joint jumbo bonds: Bremen, Hamburg, Mecklenburg-West Pomerania, Saarland, Schleswig-Holstein, Thuringia and Rhineland-Palatinate.

3. Carrot-and-stick approach of John Springfield [13]

The third option tackles this problem. It suggests to create a common government bond for the euro area but EMU countries must qualify for participation through solid fiscal consolidation in boom times. The aim is to provide a strong incentive for EMU member states to pursue sound fiscal policies in the medium term in order to increase the rating and lower the spread towards the bonds of the EMU benchmark. This implies that the proposal concerns all those EMU countries that have to pay a major spread. However, it does not deliver a fiscal policy incentive to the two benchmark countries Germany and France.

The proposal is a good idea as it deals with the Achilles heel of the reformed SGP because it promises a strengthening of fiscal discipline in boom times. However, it would require a further reform of the SGP. The European Commission as guardian of the EU treaty could play a key role in reforming the pact by proposing a good new design of the pact along the lines of this proposal and by being in charge of monitoring its implementation. However, any change in the SGP arrangement is likely to open the Pandora's box of diluting the Pact as the reform story of 2005 has shown. Any reform of the pact requires political will, which is definitely not discernible at present. Anyway, the realisation of such an option would take time. Thus, it is not yet applicable in this financial crisis. Nonetheless, this option deserves an intensive debate.

4. Germany and France should promote one liquid short-term instrument

Still, the biggest disadvantage of the government paper market of the euro area is the lack of a liquid instrument such as the US Treasury bill market. Therefore, there is an urgent need to establish a liquid short-term government bond instrument in the euro area in order to correct this competitive disadvantage. In particular, a liquid bill market is of utmost importance for the asset management of central banks around the globe. It is essential to boost the euro's role as an international reserve currency where the euro still has scope for expansion.

Two alternatives are under debate. First, the proposal of Wolfgang Münchau [14] concerns the establishment of a joint European market for treasury bills only. Again, this approach implies the risk of eroding fiscal discipline and does probably not comply with the no-bailout clause of the SGP. It might turn out to be a Trojan horse, as it would enable the introduction of a common bond in longer maturities through the back door.

Second, Germany and France, i.e. only each of the two largest EMU countries, are supposed to create a large liquid government instrument by focussing on one key maturity, for instance three months. This would have the advantage

[13] John Springfield (2009), Strengthening the Stability and Growth Pact with a common eurozone bond, European Liberal Forum, August

[14] Ibid

to bundle the provision of short-term liquidity and avoid dissipating energies on several maturities between one day and twelve months. An issue of debate should also be the type of instrument. The US Treasury bill could be a role model. The US Treasury bill are non-interest bearing. It is bought at a discount. If it is held until redemption, for instance, the discount is effectively the interest earned. A German and a French Treasury bill would have the advantage that they would be directly comparable to US Treasury bills.

V. Conclusion

There are strong arguments against the creation of a common government bond in the euro area. First, we have witnessed extensive bond market integration since 1999 without a common government bond instrument. Second, and most important, a common bond is likely to damage fiscal discipline by undermining the no-bail-out clause. Third, substantial additional costs are likely for the triple-A-rated states in terms of higher interest payments for both covering current budget deficits and refinancing maturing debt. Fourth, a common European government bond implies a burden sharing among member states if an EMU state threatens to go bust. Finally, any new "burden-sharing" is likely to stimulate euro-scepticism.

Nevertheless, the non-bail clause of the Maastricht Treaty must not be, in general, an argument to kill new ideas from the very beginning. Proposals that combine the establishment of a common government bond with incentives to enhance fiscal discipline should be subject to close review. The model of German federal states as well as the Springfield approach deserve mentioning under the roof of a reformed SGP. Last but not least, a German and French Treasury bill market with focus on one short-term maturity should be reconsidered.

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What is ELEC?

Created in 1946, the European League for Economic Co-operation (ELEC) is a non-governmental and non-party organisation that aims to promote the economic integration and socio-cultural identity of Europe, and to enhance its role in the world.

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