Now is the time for Eurobonds: A specific proposal

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Given the new geopolitical environment, there is wide agreement that Europe needs to achieve strategic autonomy. Autonomy has many dimensions. The most obvious today is military autonomy, building a solid European defense system. A less obvious one, but equally important, is achieving financial autonomy, creating a European financial ecosystem that can compete with that of the United States. And a necessary condition for such a system to function is to have at its base a deep and liquid Eurobond market.

Now is the time to build it. Global investors are increasingly questioning the soundness, safety, and stability of the dollar, and have begun rebalancing global portfolios away from the dollar. Creating a deep and liquid market of Eurobonds would provide investors with the alternative safe asset they are looking for. Failure to do it now would be missing an historical opportunity to reduce the cost of funding European public debt and, by extension, European private capital.

We know that large institutional changes, such as the creation of a new financial instrument or a new market, always entails risks and raises questions. But we are convinced that doing nothing in the face of the large geostrategic shifts we are experiencing would be much riskier.

BACKGROUND

Dating back to the euro crisis, many proposals have been made to substantially increase the size of the Eurobonds market, such as "blue-red bonds" (Delpla and Weizsacker 2010), E-bonds (Monti 2010), or "Esbies," (Brunnermeier et al. 2011), among others (see the comprehensive review in Leandro and Zettelmeyer (2019)). While the proposals offered clever ways to address worries about moral hazard and risk sharing that were prevalent at the time, none of them were implemented because of lack of political support and doubts about the soundness of creating a safe asset based on financial engineering. It is telling that when the time came for Europe to create a framework to finance the

NextGenerationEU (NGEU)program, EU leaders discarded financial engineering solutions and adopted a plain vanilla Eurobond.

The main issue today is not moral hazard or risk sharing, but the creation of a large European bond market that can boost Europe's strategic autonomy and meet the increasing global demand for an alternative to the US Treasury market. Our note builds on the lessons from the Eurobond literature and offers such a proposal.

We propose a framework for creating a deep and liquid market for safe Eurobonds. The proposal involves no or minimal risk sharing, minimal financial engineering, and no required change in EU fiscal rules (as desirable as such a change might be on other grounds). It is independent of the European Union's decisions whether to finance its spending through taxes or debt. We see it as a working document. There are many ways in which this proposal can be modified so that it passes legal, conceptual, practical, and political tests. We believe a final proposal can pass all these tests, and we believe that it is essential to start exploring now.

The underlying idea of the proposal is straightforward, namely an exchange of a volume of national bonds for senior Eurobonds. The devil is, as usual, in the details. We present the basic proposal and then discuss the various specific issues to be addressed.

THE BASIC PROPOSAL

Global investors are looking for alternatives to the US Treasury market, which, until recently, they perceived as deep, liquid, and safe. The recent downgrade of US government debt by Moody's showcases the unsustainability of US fiscal policy, and with some recent proposals suggesting the possibility of exchanging current Treasuries for non-marketable perpetual bonds, investors are starting to have questions about safety.

Today, they have no obvious alternatives at scale. The closest alternative in Europe is the bund market. But the total value of bunds is only €2.5 trillion, compared to $30 trillion for the US Treasury market. The market for existing Eurobonds is fragmented and small: EU-issued bonds, or EU-bonds, to fund NGEU for €540 billion and expected to reach €700 billion by 2026, European Stability Mechanism (ESM) bonds for €270 billion, European Investment Bank (EIB) bonds for €250 billion, for a current total of a bit over €1 trillion. While the EU now has more debt than the Netherlands and is on track to become the largest net issuer of bonds in the EU in 2025–26, these amounts are not large enough on a global scale. In addition, because of the lack of clarity about their future (EU leaders have not decided yet whether to roll over or repay the EU-bonds issued to fund the NGEU program), EU-bonds are not treated by investors as sovereign bonds, but rather as supranationals, and are not included in sovereign bond indices, reducing the demand and keeping their yields higher than otherwise.

Thus, if Europe is going to offer investors an alternative, it needs to increase the size of the Eurobond market dramatically. This cannot be done at the margin, just through net flows: If, say, all additional defense spending were to be financed entirely in this way, this would add only about 1 percent of EU GDP to the stock every year. Even if the EU budget were to substantially increase in size and finance itself largely through EU-bonds, the increase in the stock would still take many years to reach the scale it needs to achieve.

So, the solution must be to replace a proportion of the stock of national bonds with Eurobonds (call them blue bonds for the time being, leaving out for the moment the question of whether and how they might differ from existing EU-bonds).

The main issue is then how much of the national debt of EU countries should be replaced with blue bonds.

On the one hand, for the market to be deep and liquid enough, the proportion of blue debt must be high enough. What that means depends on the relation between the size of the market, the size of transactions, depth, and liquidity. Other factors being equal, the larger the market, the more likely it is to be deep and liquid and lead to the development of the necessary plumbing (bonds being accepted in central bank repurchase operations, having a deep futures market) to be effective.

On the other hand, the higher the proportion of blue debt, the higher the worry about risk sharing. A joint and several guarantee, while ideal in theory, is probably not feasible in practice, as small EU countries would be liable for an enormous amount of debt relative to their GDP. We believe blue debt should be senior, in both a political and legal sense. Perceived safety will then depend on the strength and credibility of the commitments of governments to pay the interest payments on their part of the blue debt (equal to the part of the blue debt issued in exchange to national debt). For example, governments could commit under domestic law to allocate the required value-added tax (VAT) revenues to interest payments on the blue debt (directly, or if not feasible legally, by paying the required VAT revenues to the EU budget, and the EU budget in turn making the interest payments). Even if so, the larger the proportion of blue bonds to total debt, the more risk sharing may become an issue, and thus the right balance must be stuck.

Is there a sweet spot where the proportion of blue bonds is large enough to provide the required liquidity but small enough that, given seniority, the blue bonds are not at risk? Our belief, based on discussions with market participants, is that exchanging national bonds for blue bonds up to 25 percent of GDP may be enough for liquidity purposes and still not raise issues about safety. At the eurozone level, this would leave the national debt-to-GDP ratio at around 60 percent and, considering the coming increase in debt-to-GDP ratio implicit in German fiscal plans, it would leave the national debt-to-GDP ratio for the big four eurozone countries—France, Germany, Italy, and Spain—at or above 60 percent of GDP. We suspect that the ratio of blue bonds to GDP can be substantially higher once EU countries see that the governance framework works, but an initial goal of 25 percent, or equivalently about €5 trillion, may be appropriate.

There would then be two types of bonds, senior blue bonds and junior national bonds. What would be the interest rates on each type?

Assuming first that spreads reflect only default risk on the initial national debt, the implication would be a lower rate on the senior blue bonds and a higher rate on national bonds, reflecting the fact that the risk would now be concentrated on a narrower base. The average cost of funding would remain the same.

The outcome should however be more favorable than this. Global investors' demand for a deep and liquid market for the safe asset should be reflected in an even lower safe rate than, say, the bund rate today (this is not the case today for EU-bonds, precisely because of the narrowness of the market and their supranational rather than sovereign status). The larger size of the market also implies that the rest of the required ecosystem, such as a deep

yield curve, a futures market, and ease of repo for blue bonds, would naturally develop, leading again to lower rates. Also, because of home bias as well as regulatory constraints (for example, the mandate in the Spanish Pension Reserve Fund to allocate a portion of its assets to Spanish bonds), the remaining demand for national debt may remain high and, given the smaller supply, lead to less of an increase in the rates on national debt. Could things go the other way? The evidence is that markets treat new instruments with prudence, leading initially to higher spreads. The effect however is likely to go away over time. (The spread on 10-year NGEU bonds, which started at 35 basis points, is now closer to 20 basis points.)

One can think of other effects lowering all rates, public and private. The increase in the sensitivity of rates on remaining national debt should strengthen incentives for countries to stay in good standing with the EU fiscal rules and adopt disciplined fiscal policies. A deep and liquid market for blue bonds should facilitate the creation of a reliable European corporate bond yield curve that can foster capital market integration and allow for better risk management by European banks by reducing the national bank–bond correlation.

To summarize: As argued by the authors of various earlier proposals, such a two-tier system—one safe rate and 20 national rates—should lead to a lower average interest rate for each member while giving stronger incentives for countries with a worse fiscal outlook to adjust.

ISSUES: EXCHANGE, SENIORITY, TYPE OF BONDS, PARTICIPATION, RELATIONSHIP WITH EU BUDGET

THE EXCHANGE

Should the exchange take place through market purchases of national bonds or through replacement of national bonds when they come to maturity, in both cases financed by the parallel issuance of blue bonds? The answer may be a mix of both.

Market purchases. In this case, the EU (presumably the Directorate General for the Budget, which has handled the issuance of NGEU bonds) would buy back national bonds and separately issue blue bonds for the same amount. (The word ``exchange '' may be misleading in this context, as there would no actual exchange of one for the other, just a coincidental purchase of national bonds and issuance of blue bonds. Sellers of national debt would be under no obligation to buy the new blue bonds. Indeed, making it an actual exchange would raise complex legal issues). The advantage of market purchases of national bonds is that they are faster to deploy. While the scale of this operation would certainly be much larger, it would be similar in spirit to the regular debt buybacks that debt management offices execute to improve liquidity and manage the shape of the yield curve.

Replacement of maturing bonds. Such replacement avoids the potential issues associated with market purchases, but it would be a much slower process and has its own shortcomings. The first is that the existing maturity structure of the national bonds determines what maturity bonds are taken out of the market. In contrast, the advantage of market purchases is that they allow the issuing agency to buy whatever maturity bond they want to buy. Replacement may thus lead to an unappealing maturity structure for the remaining national bonds during what could be a long transition period. On net, given the constraints on maintaining an attractive maturity structure, the pace at which the market for blue bonds would increase via replacement is likely to be too slow.

Yet another, not exclusive, alternative is to replace the national bonds on the European Central Bank's (ECB) balance sheet, in part or in total. If in total, their value is around €2 trillion, which would leave about €2 trillion of blue bonds to be created by other means. While this would not preclude the ability of the ECB to buy national bonds in a future asset purchase program, it would alleviate the constraints the ECB faces regarding the percent of bonds of each country that it holds and provide the ECB with an additional instrument to conduct its policies. However, the more blue bonds the ECB holds on its balance sheet, the fewer blue bonds will be available on the market, potentially defeating the purpose of the project. Thus, replacing national bonds with blue bonds makes sense only if the ECB intends to reduce the size of its balance sheet over time, so that the bonds become available over time on the market. In any event, the ECB's inclusion of the blue bonds in its purchase operations and its future structural portfolio would be critical to ensure that blue bonds are not seen by markets as "inferior" to the national bonds.

All in all, a mix of exchange and replacement, perhaps with some participation of the ECB, would likely be optimal. Market purchases would allow for a faster and better management of yield curves. The replacement over a few years of national bonds would reduce their rollover risk and keep their yields lower. In the end, the promise of a multiyear plan to achieve the goal of a 25 percent ratio of blue bonds to GDP should be enough to attract flows into European capital markets.

SENIORITY

A general issue, independent of which method is used, is that of seniority. We do not think that, from the point of view of national debt, the seniority of blue bonds raises any legal concern. Other things being equal, the exchange makes national bonds de facto riskier. However, this is true of any government decision, for example, the promise of more generous retirement benefits, which changes the riskiness of the national debt, and we are not aware of any pari passu clause that would prevent the exchange, in whatever form, from taking place. (Note also that the issue is already present with existing EU-bonds, which are also backed by a share of national revenues— the national contributions to the EU budget—and thus are, from this standpoint, already de facto senior to national bonds.) And other things are not equal: An EU with Eurobonds is a more stable economic area, making each of its members more stable as well, as we saw with NGEU during the COVID-19 crisis. Still, there may be the worry that a stronger effect of default risk on national bond spreads may increase the risk of a self-fulfilling run. The fact however that the ECB has adopted asset purchases as part of its monetary policy toolkit and the existence of the Transmission Protection Instrument (TPI) have considerably reduced the odds of such self-fulfilling runs. Spreads will vary across countries, reflecting perceptions of liquidity and default risk, and this is fine.

BLUE BONDS AND EXISTING EUROBONDS

Another issue is the relation of blue bonds to existing Eurobonds. While Eurobonds already enjoy the advantage of existing infrastructure, including a futures market for EU-bonds, the issue here is that the backing is not the same for the different bonds: the commitment to use the EU budget for the NGEU bonds, the existence of a capital buffer for ESM and EIB bonds. How to achieve the optimal consolidation would be a political decision for EU leaders (the EIB as a bank may want to keep its own balance sheet), but there is no obvious reason to keep ESM bonds, EU-bonds, and blue bonds segregated.

Consolidation would boost market size, improving liquidity and efficiency and keeping rates lower than otherwise.

PARTICIPATION

Participation in this program should be open to all EU member states without restrictions. In some countries however, the ratio of debt to GDP is low, and an exchange of 25 percent of GDP for blue debt may not be attractive, as it would leave too little for national bonds. These countries could choose not to participate or to participate at a lower than 25 percent level, and in that case their contribution to interest payments would be accordingly lower. If, for some reason, a country decided to decrease its share, it could do so by buying back blue bonds and issuing national bonds instead. If a country decided to leave the EU, it could either do the same or commit to pay the interest rate on its share of the blue bonds. (In the withdrawal agreement it signed with the EU upon Brexit, the UK agreed to pay €30 billion to make good on pensions and other commitments.)

BLUE BONDS AND THE EU BUDGET

Finally, and importantly, this proposal does not take a stand on whether the proportion of blue bonds should be increased over time, how that proportion interacts with the size of the EU budget, what spending priorities the EU should have, and how much of EU spending will be financed by taxes or debt. To the extent that EU spending is partly financed by debt, the existence of a large blue bond market implies that financing should be cheaper than it is today (as the EU-bonds have marginally higher rates than bunds due to their supranational nature, smaller size, and liquidity).

In short, a proposal along the lines we have sketched out would help defragment European sovereign debt and create a large and deep market, while not creating risk sharing nor creating any new mandate for the EU. There are many issues to be resolved, but we believe none of them is insurmountable. Now is the time to build.

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DATA DISCLOSURE

This publication does not include a replication package.