Does Europe need a Eurobond? The Blue-Bond Proposal

With Jacques Delpla, Jakob von Weizsäcker and Karsten Wendorff
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*On the 11th of May, Bruegel hosted **Jacques Delpla**, member of the Council of Economic Advisers to the Prime Minister of France, **Jakob von Weizsäcker**, Non-resident Fellow at Bruegel and Head of Department at the Thüringer Ministerium für Wirtschaft, Arbeit und Technologie, and **Karsten Wendorff**, Deputy Head of Economics Department and Head of Public Finance Division at the Deutsche Bundesbank, for a discussion on Eurobonds. The event took stock revisited and updated the Blue-Bond proposal put forward in Delpla and von Weizsäcker (2010) and the collective action clause proposal of Weber, Ulbrich and Wendorff (2011) in the context of current events, discussed alternatives, and addressed the main points of contention. **Zsolt Darvas**, Research Fellow at Bruegel, chaired the discussion.*

Jacques Delpla and **Jakob von Weizsäcker** first outlined the "Blue Bond Proposal" in May 2010. The design of the scheme pursues two objectives: reduce borrowing costs for the years to come, whilst ensuring that market pressures serve fiscal discipline in euro area countries. To reach these two objectives, the following mechanism was proposed: debt would be broken down into two tranches, "blue" debt (up to 60% of GDP) and "red" debt for amounts outstanding above the 60% threshold. Blue debt would be pooled and merged by all euro area countries, and given seniority status with respect to red debt. Joint and several liability for blue debt would ensure that it obtains the highest possible credit rating.

These three elements from the proposal combine to ensure lower borrowing costs. The homogenous asset created by the pooling of blue-debt liabilities would create a bond market, according to the authors, similar in size to the US Treasury Bond: between 5000 and 6000 billion €, compared to 7250 billion € for the United States. The authors, **Jacques Delpla and Jakob von Weizsäcker,** calculate that the increased liquidity could reduce borrowing costs by as much as 30 basis points, corresponding to a 10% decrease in the interest burden – ensuring that even fiscally strong countries such as Germany would gain from the scheme. The authors assert that the deeper market could greatly accelerate the emergence of the euro as serious reserve currency.

The amount of debt outstanding above the 60% threshold would be given "red debt" status: issued by national Treasuries, it would not be guaranteed by the other member states. Junior to blue debt and subject to investor participation in the case of a default, borrowing costs would thus be higher as all of sovereign risk would be concentrated on the red tranche. This set-up would ensure that individual countries have a strong incentive to commit to fiscal responsibility. Moreover, the 60% threshold could be construed as an upper limit and set at a lower level for countries with weak fiscal positions.

To ensure that the threat of default on the red tranche is credible, the authors recommend that red debt be kept out of the banking system. This could be done by requiring banks to hold prohibitive amounts of capital against red debt holdings, and by not granting it eligibility for ECB refinancing operations. In the event of a crisis, creditor involvement could be facilitated by the inclusion of provisions in debt contract. For example, debt contracts could allow for automatic extension of maturities when a country enters a EU/IMF program, and for all coupon payments occurring during that period to be forfeited. All of these elements would ensure complementarity between the Blue Bond proposal and the European Stability Mechanism (ESM): by ensuring a credible threat of default, and allowing for the automatic rollover of maturing debt, ESM loans would only need to cover primary deficits and the required size of the facility would be limited.

Karst Wendorff followed up on the presentation by **Jacques Delpla and Jakob von Weizsäcker**, insisting on the need for consistency with the "*letter and spirit"* of EU Council decisions. He did not reject Eurobonds in principle, but stated that the design of the EU framework needed to allow for such instruments. Joint

liabilities would, his presentation claimed, imply some form of common decision on economic policies – something that is, in the current framework, still out of the question. Implementing the Blue Bond proposal would require both EU Treaty and German Constitution changes. In response to this, **Jacques Delpla** asserted that no treaty changes would be necessary, as the scheme is not federalist in nature and does not involve issuance of bonds by the European Union or the European Commission. The scheme is designed as an intergovernmental device, with democratic accountability and no delegation of power. However, **Karst Wendorff** remarked that there was no way to prevent a country from democratically defaulting against its Blue Bonds.

Karst Wendorff also expressed skepticism at some of the key economic arguments for Blue Bonds. With the threshold at 60% of GDP, the scheme could weaken market discipline to the extent that it would diminish the incentive to keep debt levels below this threshold. However, the proposal already allows for the possibility of lower allocations for countries in a weak or unsustainable fiscal position. He also expressed doubts as to the magnitude of the rate-lowering effect of additional liquidity. He suggested that the introduction of Blue Bonds without the joint and several liability clause could be a useful alternative: it would solve the institutional problem, and the preferred creditor status would ensure lower borrowing costs. If the debt outstanding below the 60% threshold is "truly" safe, as claimed by Jacques Delpla and von Weizsäcker, then it would benefit from triple-A status regardless of joint liability.

Karst Wendorff then presented an alternative proposal – dubbed the "3+ Bond Proposal" – that he put forward in a recent article with **Axel Weber** and **Jens Ulbrich** of the Deutsche Bundesbank. The scheme would reproduce some of the desirable effects of the Blue Bonds proposal and be compatible with the currently existing EU and euro area frameworks. The authors propose a "*compulsory incorporation of a provision into the standard terms and conditions for future euro-area government bonds: if the granting of ESM assistance is confirmed, the maturity of bonds is extended by three years".*

The proposal, the authors claim, would strengthen the credibility of the threat to restructure, thus ensuring that the risk is *ex*-ante priced into bonds by investors. It would also reduce the necessary size of the ESM, as with the Blue Bond proposal, by ensuring that existing debt is automatically rolled-over in the event of a crisis. Moreover, it could limit some of the implications of the preferred creditor status for ESM loans that was decided by the European Council: namely that long-term investors would bear all of the haircut in the event of a restructuring (while short-term investors would recoup all of their investment), which creates a problem both of equity and of financial stability. Automatic maturity extensions would ensure that default risk is spread evenly across all maturities, and limit the risk to financial stability by reducing the incentive for investors to divest themselves of longer-dated bonds if restructuring appears imminent. **M. Wendorff** suggested that the scheme would be especially useful for countries with "good" track records that have simply run into "bad luck", as they would not have to bear the somewhat punitive rates of assistance programs.

Both during the presentation and in the discussions, **Karst Wendorff** highlighted the fact that the "3+ Bond" also eliminated the need to distinguish *ex-ante* between solvency and liquidity crises. **Jakob von Weizsäcker** underlined the fact that the "3+ Bond" proposal was, in effect, purely a liquidity device and did nothing to address solvency issues, which was acknowledged by the author of the proposition. In the case of solvency problems, haircuts remain the only real solution. Several members of the floor remarked that the lack of a sustainability assessment was not necessarily a desirable feature, as it simply served to postpone inevitable default (based on the argument that restructuring, where necessary, should be carried out sooner rather than later). During the ensuing discussions, **Jacques Delpla** and **Jakob von Weizsäcker** highlighted the similarities between the "3+ Bond" proposal and the red debt. They stated that the idea was a good one, and **Jacques Delpla** asserted that it was better than the simple inclusion of Collective Action Clauses (CAC's), which create uncertainty as to the outcome of a restructuring.