Joint debt instruments
A recurrent proposal to strengthen economic and monetary union

SUMMARY
The idea of issuing joint debt instruments, in particular between euro-area countries, is far from new. It has long been linked in various ways to the Union’s financial integration process and in particular to the implementation of economic and monetary union. In the first decade of the euro, the rationale for creating joint bonds was to reduce market fragmentation and thus obtain efficiency gains. Following the financial and sovereign debt crises, further reasons included managing the crises and preventing future sovereign debt crises, reinforcing financial stability in the euro area, facilitating transmission of monetary policy, breaking the sovereign-bank nexus and enhancing the international role of the euro.

While joint debt instruments present considerable potential advantages, they also present challenges. These include coordination issues and reduced flexibility for Member States in issuing debt, the potential to undermine fiscal discipline by removing incentives for sound budgetary policies, and the fact that adoption of joint debt instruments would eventually entail the difficult political choice of transferring sovereignty from the national to the EU level.

In the context of the current crisis caused by the COVID-19 pandemic, joint debt instruments have once more come to the fore as a potential medium-term solution to help Member States rebuild their economies following the crisis. In Eurogroup and European Council meetings, the solution is not favoured by all Member States and alternative – possibly complementary – approaches have been proposed, such as a credit line through the European Stability Mechanism.

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Introduction

To cope with the emergency generated by the spread of COVID-19 among EU Member States, several commentators have highlighted the need to activate supranational sources of finance alongside national fiscal measures, including joint liabilities often referred to generically as ‘eurobonds’ or ‘coronabonds’. The various stakeholders supporting this view include the Governor of the Bank of Portugal and a group of leading German academics. The hypothesis was also taken up by the leaders of nine EU Member States and seemingly was examined informally during the video-conference of EU leaders on 26 March. However, no breakthrough was achieved during this conference. Instead, the leaders gave the Eurogroup two weeks to come up with new proposals on further action, to be gradually stepped up as events unfold ‘in order to deliver a comprehensive response’.

An evolving idea

The idea of issuing joint debt instruments, in particular between euro-area countries, is far from new. It has been linked in various ways to the Union’s financial integration process, and in particular to the implementation of economic and monetary union (EMU), from the outset.

Before the global financial crisis: Increased market efficiency

In November 2000, following the advent of EMU, the ‘Giovannini group’, whose original task was to investigate obstacles to cross-border transactions in EU financial markets, produced a report on the issue of coordinated public debt issuance. The group began by noting that, whereas considerable harmonisation of national market conventions had already been achieved in the run-up to the euro, important differences remained in issuance techniques and instruments used by national debt agencies. These differences were a source of market fragmentation, which translated into euro-area yield spreads. By reducing market fragmentation, greater coordination in debt issuance would therefore result in efficiency gains.

The group considered four hypotheses for tighter coordination in debt issuance, ranging from a limited extension of current procedures, to the most advanced form of coordination, involving the establishment of a single benchmark issuer for the euro area as a whole. In the absence of unanimity in the group concerning the preferred option, and given that the context for assessing the merits of coordinated public debt issuance could change significantly in the coming years (owing to the rapid pace of structural change in euro-area financial markets), the group decided to monitor the issue, and to hold back on concrete suggestions for the time being.

Managing the financial crisis and preventing new ones

Academics’ views

One consequence of the global financial crisis and the European sovereign debt crisis that followed was that spreads between the yields of securities issued by ‘peripheral’ countries and the German Bund increased dramatically. That resulted from investors pricing in the risk that a political breakdown of the euro could result in sovereign bonds issued by the euro-area countries being redenominated in reborn national currencies. A number of measures were taken to tackle the issue, including the establishment of the European Stability Mechanism (ESM), which provides financial support for euro-area sovereign issuers at risk of losing access to the markets, subject to stringent conditions. In this context, several academics and institutions revived the idea of eurobonds. This time, however, instead of focusing on the benefits of greater market efficiency through increased liquidity in sovereign bond markets, the perceived benefit related to managing the crisis and preventing future sovereign debt crises, reinforcing financial stability in the euro area, facilitating the transmission of monetary policy, and (only then) improving market efficiency.
In a 2010 paper written for the European Parliament, Carlo Favero and Alessandro Missale outlined the three main groups of proposals formulated up to then.

The first group of proposals consisted of a single debt instrument issued by a group of euro-area Member States, through an independent agency, with funds raised and obligations divided between participating issuers in specific fixed proportions. Each participating Member State would guarantee only its share of the joint instrument. While the eurobond would trade as a single debt instrument, each participant would be liable only for the debt servicing (i.e. interest payments) and principal redemption corresponding to its share of the bond, and not for the debt of the other issuers. The credit standing of this bond would likely emerge and be perceived by investors as the average of the credit standings of the participating Member States (weighted by their relative shares), while its liquidity could be greater than that of national bonds of the participating issuers depending on the size that its market reached. The authors noted that one proposal characteristic of this first group was that formulated by Paul De Grauwe.5

The second hypothesis was a single debt instrument issued by a group of euro-area Member States backed by several and joint guarantees: under this scheme, each participating issuer would guarantee the totality of the obligations of the common instrument, thereby making it an indivisible legal object. The issuing entity could be an independent agency or, a newly created EMU fund for on-lending to a group of participating euro-area Member States. The debt-service obligations of each participating issuer would be specified in relation to the amount of funding obtained, but the cross-default nature of the joint guarantees would give an investor legal recourse to all the participating issuers, in the event that not all the obligations of any issuer were fully met. Thus, the credit standing of this instrument would tend to reflect the creditworthiness of the participating Member States with larger economies. Participation by Germany and France would ensure a lower credit risk premium than the weighted average of the participating Member States even if some of them were of lower credit ratings. According to the authors, the ‘blue-red bonds’ proposed by Jacques Delpla (and later MEP Jakob von Weizsäcker) were representative of this category.6

The last group involved a debt instrument issued by an EU institution for on-lending to Member States. This institution would lend the funds raised with EU bonds to Member States at an interest rate reflecting funding costs plus, possibly, a margin that might differ across Member States. EU bonds would be backed by the several and joint guarantees of all EU Member States; these guarantees would not be explicit but derive from the EU legal order. If the common bond was issued by the European Commission, the guarantees would derive from the legal obligations of the Member States under the EU Treaty. If the bonds were issued by the EIB, they would be backed by the capital underwritten by EU Member States. In both cases, EU bonds would be of the highest credit quality and their risk premium should be close to zero. A proposal representative of this last group was that formulated in 2005 by Alberto Majocchi.7

**Initiatives by EU and other institutions**

European Parliament resolution

In its July 2011 resolution, 'Financial, economic and social crisis: measures and initiatives to be taken', the European Parliament called on the Commission to carry out an investigation 'into a future system of Eurobonds', pointing out that eurobonds 'would offer a viable alternative to the US dollar bond market, and that they could foster integration of the European sovereign debt market, lower borrowing costs, increase liquidity, budgetary discipline and compliance with the Stability and Growth Pact, promote coordinated structural reforms, and make capital markets more stable'.

European Commission green paper

Later that year, the Commission grouped some of the aforementioned proposals together in a green paper, in which it examined the feasibility of ‘stability bonds’, i.e. sovereign bonds issued in common among euro-area Member States. Noting the significant benefits, but also challenges, involved with their introduction, the Commission grouped the options for common issuance into three...
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approaches, presenting their trade-offs, the necessary changes in the existing fiscal framework, and various implementation issues.

Figure 1 – First approach: Full substitution of national issuance with stability bonds, with joint and several guarantees.

Source: Graphic interpretation of European Commission green paper, EPRS.

In this case, countries would be responsible not only for their own percentage contribution to the bond, but also for covering the unpaid contributions of any other state.

Figure 2 – Second approach: Partial substitution of national issuance with stability bonds with several and joint guarantees reinforced with other guarantees.

Source: Graphic interpretation of European Commission green paper, EPRS.

In the second case, the Commission suggested (i) assigning some countries senior status in stability bond issuance, (ii) backing up issuances with collateral such as gold, shares in public companies,
etc., and (iii) devoting parts of governments’ revenue streams to payment of these bonds (see the blue bonds proposal (Delpla) mentioned above).

Figure 3 – Third approach: Partial substitution of national issuance with stability bonds, which would have several but not joint guarantees.

Source: Graphic interpretation of European Commission green paper, EPRS.

Under this third approach, each country would be responsible for a percentage contribution to each redemption (see proposal by Paul De Grauwe mentioned above).

The Commission noted that the first approach could be considered the most ambitious, as it would deliver the greatest results in terms of market integration and strengthening stability, but might take considerable time to implement. Conversely, the third approach, with its different scope and guarantee structure, seemed to be more easily ready for relatively rapid deployment. Hence, there was a certain trade-off between ambition in the features and scope of the stability bonds and possible speed of implementation. To overcome this trade-off, the Commission noted that the various options could be combined as sequential steps in a gradual implementation process.8

Proposal from the German Council of Economic Experts

Shortly before the Commission’s green paper came out in 2011, the German Council of Economic Experts formulated a major proposal, the European Redemption Pact, requiring Member States to engage in a binding consolidation of their sovereign debt in return for support in a time of liquidity crisis. Under this proposal, the public debt of participating Member States would be split into a part compatible with the Maastricht target of 60 % of gross domestic product, and a part exceeding that threshold to be transferred to a common 'redemption fund' for which the participating members would be jointly liable. At the same time, each country would have to commit to a binding consolidation path, under which it would be obliged to repay the transferred debt autonomously over a period of 20 to 25 years.9 Throughout the period of this mechanism, euro-area Member States would cover their funding needs (for the repayment of outstanding bonds and new borrowing) via the redemption fund until the credit facility was fully utilised. Thanks to the joint and several guarantees for the fund, highly indebted member countries would pay a lower interest rate on their transferred debt. While the fund involved common issuance, the Commission was of the view that it did not constitute stability bonds within the meaning of its green paper, because common
issuance under this proposal would be temporary and used only for Member States with public debt ratios above 60% of GDP.\textsuperscript{10}

Parliament considered the feasibility of the Commission green paper proposal in an own-initiative resolution adopted in January 2013. While stressing that all existing and future instruments that were part of the economic governance framework of the EU needed to be democratically legitimised, it welcomed as beneficial the prospect of common bonds. It therefore called on the Commission to present a report to Parliament and Council examining the options for a roadmap towards common issuance of public debt instruments, paying particular attention to the feasibility of introducing a redemption fund. It called on Member States to consider the introduction of short-term debt in the form of eurobills, as well as to study the feasibility of moving towards a system of 'European safe bonds' (see below) or other proposals based on the concept of a basket of bonds. In addition, it noted that a system of partial substitution of national issuance (such as the blue-red bonds) might have significant benefits.

Following the crisis: Breaking the sovereign-bank nexus

The term 'sovereign-bank nexus' (or loop) is used to describe the link between the creditworthiness of a country's government and that of its banks. According to Markus K. Brunnermeier et al., the deterioration of sovereign creditworthiness in Greece, Ireland, Italy, Portugal and Spain during the sovereign debt crisis reduced the market value of their domestic banks' holdings of domestic sovereign debt. This drop in value in turn reduced the perceived solvency of domestic banks and curtailed their lending activities. The resulting bank distress increased the likelihood of them needing to be bailed out by their governments, which led to further sovereign distress, engendering a 'bailout loop'. In addition, the impact of reduced loans led to a drop in tax revenue, also helping to weaken government solvency in these countries, triggering a 'real-economy loop'.

To break this loop, in 2011, a group of economists (the 'Euro-nomics group') proposed that securities should be issued by a European debt agency (EDA) composed of the senior tranche on a portfolio of sovereign bonds issued by EU Member States, held by that agency and potentially further guaranteed through a credit enhancement.

In 2018, based on this proposal, the Commission itself published a proposal for a regulation on sovereign bond-backed securities (SBBS), a new class of low-risk securities backed by a diversified pool of national government bonds. Parliament voted a resolution in plenary on 16 April 2019 to conclude its examination in first reading and preserve its position for the following term. However, discussions in the EU Council on this legislative proposal are at a standstill. During his parliamentary hearing in October 2019, Vice-President Valdis Dombrovskis acknowledged that the Commission would need to 'try to reinvigorate this discussion' on the creation of a European safe asset.

Further arguments in support of joint debt instruments

In addition to the arguments set out above, Wolfgang Munchau notes two more elements supporting the issuance of eurobonds.

First, increased fiscal-monetary coordination: according to Munchau, the eurobond would be the ideal asset-purchase instrument for the ECB, as in a crisis the stability of the euro area would not be endangered by Member States defaulting on their debt. Also, when the crisis ended, eurobonds would still constitute ideal instruments 'to plug the dearth of public-sector investments that has already arisen as a direct consequence of the stability rules'.

Second: the international role of the euro: like a number of commentators, Munchau notes that the current export-driven, primary-surplus model of the EU has made it possible for countries such as the United States or China to issue blackmail threats (e.g. Huawei, Nordstream 2 or the Iran sanctions). He is of the view that a mutualised asset, if combined with deep capital-market integration, would have allowed the EU to use the euro as a foreign policy instrument. Moreover,
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such an instrument would help the EU pursue bigger goals, such as moving in the direction of having an effective security policy.11

In a recent article, Lorenzo Bini-Smaghi focuses meanwhile on the feasibility of such a scheme. Formerly a member of the executive board of the ECB, he notes that the adoption of eurobonds ‘entails a major political choice to transfer sovereignty, on a whole range of issues, from the national to the European level’ – he posits as an example the possible transfer of health systems from national to European competence, as a means to enable the EU to generate new fiscal proceeds to ensure the highest credit rating for eurobonds.12

Arguments against joint debt instruments

In their 2010 paper, Favero and Missale outlined the three main arguments generally put forward against eurobonds.

The first was that the launch of a eurobond would add a new market to existing national markets and thus increase rather than reduce fragmentation. The second was that centralised funding would raise coordination issues and would reduce flexibility in the pursuit of country-specific debt management objectives that would have to be accommodated on national bond markets. However, the strongest argument, according to the authors, was that such bonds would undermine fiscal discipline by removing incentives for sound budgetary policies. At worst, it could create a moral hazard problem, in that a Member State could be tempted to freeride on other Member States’ legal obligations to assume its debt in the event of default.13 This last point has been the main argument of those opposing eurobonds over the past decade. The Dutch Minister of Finance, Wopke Hoekstra, reportedly told Dutch members of parliament as recently as 24 March 2020 that a eurobond would bring moral hazard, and would take away incentives to reform. Despite Hoekstra having since retracted those comments, this view seemed to hold sway in the EU leaders’ video-conference on 26 March 2020.

Ongoing considerations

In a recent interview with the Financial Times, the Managing Director of the European Stability Mechanism, Klaus Regling, highlighted two more aspects related to the creation of eurobonds that should be considered. First, it takes time for a new institution to issue European debt. Second, if such an institution were to be used, it would need capital or guarantees or the assignment of future revenues. Here, his views echo those of Bini Smaghi who, in the above-mentioned article, noted that a necessary precondition for the EU to be able to finance such bonds would be ‘a broad transfer of economic and social competences from the national to the European level’. In the short term, therefore, Regling was of the view that it would be preferable to use existing institutions (ESM) and existing instruments.

In this context, in a recent proposal (21 March), Agnès Bénassy-Quéré et al. suggest a complementary solution, should political appetite not be sufficient to make the leap to joint issuance. The idea is to establish a COVID-19 credit line through the European Stability Mechanism with a long duration, specific access conditions and ex-post conditionality,15 to be used by Member States to finance the COVID-19 relief effort. The authors specify that allocation across Member States should be proportionate to the severity of the public health and economic challenges encountered. The duration of these credit lines should be very long because Member States will emerge from the COVID-19 crisis severely weakened and will not be in a position to repay soon. Consequently, the new bonds issued by the ESM should be of very long maturity, though at maturities for which there is a market.

A similar proposal was debated during the Eurogroup meeting on 24 March. According to the reporting letter sent by Eurogroup President Mario Centeno to the President of the European Council, Charles Michel, ahead of the video-conference of 26 March, Eurogroup ministers agreed that the resources of the European Stability Mechanism should contribute to a coordinated EU
response to the COVID-19 crisis. They also supported the idea of making a ‘pandemic crisis support safeguard’ available, under the European Stability Mechanism Treaty, building on the framework of the existing Enhanced Conditions Credit Line (ECCL). Centeno added that the European Stability Mechanism could set around 2% of Member State GDP as the benchmark, to be further adjusted for each Member State according to how severely it was impacted by the crisis. Moreover, the European Stability Mechanism credit line support would be used specifically for the health and wider economic costs of responding to the COVID-19 pandemic.

MAIN REFERENCES


Bini Smaghi L., Corona bonds – great idea but complicated in reality, VoxEU, 28 March 2020.


ENDNOTES

1 According to the Reuters article, Governor Costa noted that ‘One option that deserves further analysis is the possibility of having the ESM issuing “Corona bonds”, with the proceeds being channelled to all Member States in need’. Such bonds would be repayable through the EU’s long-term budget and would have very long maturities of several decades to dilute yearly contributions by Member States. Proceeds would finance the coronavirus relief effort proportionately to the severity of the health crisis and economic woes brought by it.


3 The group noted that some issuers were obliged to offer a premium greater than would seem to be justified simply by their credit risk.

4 Namely (i) further coordination on technical aspects of debt issuance for some or all of the Member States, (ii) a joint debt instrument underpinned by the several guarantees of the participants, (iii) a single debt instrument, but backed by the joint and several guarantees of participating issuers and (iv) borrowing by a Community institution for on-lending to Member States.

5 In his paper, Paul De Grauwe summarises his proposal as follows: ‘The Eurobond issue would have the following characteristics. First, each euro government would participate in the issue on the basis of its equity shares in the European Investment Bank. Second, the interest rate (coupon) on the Eurobond would be a weighted average of the yields observed in each government bond market at the moment of issue. The weights would also be given by the equity shares in the European Investment Bank. Third, the proceeds of the bond issue would be channelled to each government using the same weights. Fourth, each government would pay the yearly interest rate on its part of the bond, using the same national interest rates used to compute the average interest rate on the Eurobond’.

6 Under this proposal, EU countries should pool up to 60% of GDP of their national debt under joint and several liability as senior sovereign debt (‘blue bonds’), thereby reducing the borrowing cost for that part of the debt. Any national debt beyond a country’s blue bond allocation should be issued as national and junior debt (‘red bonds’) with sound procedures for an orderly default, thus increasing the marginal cost of public borrowing and helping to enhance fiscal discipline. Blue bond allocations to Member States would be proposed by an independent stability council and voted on by Member States’ parliaments in order to safeguard fiscal responsibility.

7 The author notes that ‘The basic idea is that the different projects envisaged in the Lisbon Strategy could be funded through project financing or public/private partnerships, depending on the different degrees of risk/profitability involved. The public share could be divided between the Member States and a European Lisbon Agency, which could get the funds from the market by emitting Union bonds through the European Investment Bank. The private sector involved in the projects could get funds either from the market or the European Investment Bank. The European
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The budget would cover the interest payments on the bonds emitted on the market and the costs of interest allowances granted to the European Investment Bank.

8 ‘A relatively early introduction based on a partial approach and a several guarantee structure, combined with a roadmap towards further development of this instrument and the related stronger governance’.

9 The authors noted that ‘This is roughly equivalent to the debt reduction rule contained in the Stability and Growth Pact (SGP), which stipulates that excess debt above the 60 per cent ceiling must be reduced at an annual rate of 1/20’.

10 The Commission noted that ‘Instead, the German Council of Economic Experts proposes to introduce a temporary financing tool that would give all euro-area Member States time, and financial breathing space, to bring their debt below 60 % of GDP. Once this goal is reached the fund and safe bonds will be automatically liquidated’.

11 The author notes characteristically ‘The Germans may never agree to increasing their domestic defence budget, especially when the perceived fiscal space is reduced. But Germans may have fewer qualms if the expansion of security policy occurs one level higher up’.

12 Decisions on health issues – hospitals to close or open, salaries, procurement, insurance, etc. – would be decided in Brussels, including overall spending and how to finance it (either through revenues or debt).

13 The authors noted, in particular, that a common eurobond would prevent financial markets from exerting their disciplinary effects through higher interest rates and undermine the no-bailout clause that prohibits a Member State from being liable for or assuming the debt obligations of another government. Then, with lower costs of default and deficit financing, Member States would be encouraged to run lax fiscal policies and take up more debt. This would weaken the credibility of the eurozone as an area of fiscal stability.

14 The – currently available – Enhanced Conditions Credit Line of the European Stability Mechanism can lend for only one year, with possible extensions up to another year.

15 The authors note that while conditionality is necessary, it should be minimal and involve Member States committing to be transparent in the use of the COVID line and not to introduce new discretionary spending or tax reduction measures that are not COVID-related, and to wind down the COVID relief effort once the crisis is over.

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