An Idea to Revolutionize Europe's Debt Could Be Coming of Age

Mario Draghi is paying attention to the concept of European Safe Bonds

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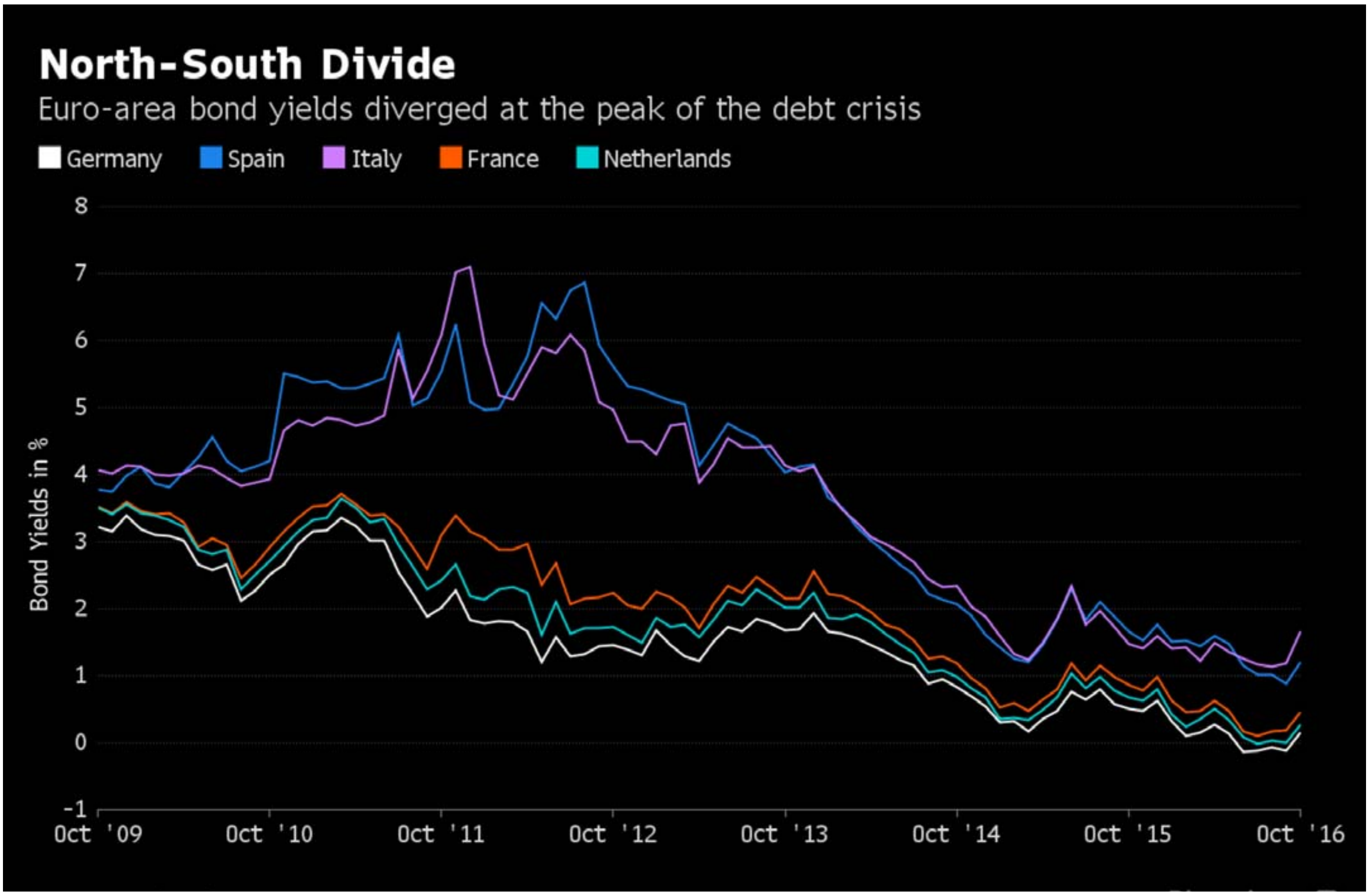
What if it were possible to create a government bond for the euro area that was seen as a safe asset, without that meaning Germany has to stand behind the debts of others? Consider it done, almost.

The European Safe Bond <https://www.esrb.europa.eu/pub/pdf/wp/esrbwp21.en.pdf?78c259326d82ec15a0918ffd5a094373> is, in theory, a parcel of euro-area government debt of different risk grades that would provide the 19-nation currency bloc with a single "safe asset" that's not linked to the fate of any individual member. Previously, the perception of all European government debt as safe, when it clearly wasn't, was one of the things that caused the sovereign debt crisis.



The idea to fix that via so-called ESBies has been doing the rounds in academic circles for a number of years now, since a group of economists including Princeton University professor Markus Brunnermeier <http://scholar.princeton.edu/markus/home> first proposed it in 2011.

But it's only now that the idea is getting serious attention from policy makers. An expert panel of the European Systemic Risk Board, reporting to European Central Bank President Mario Draghi, is studying the concept. Last week, ECB board member Benoit Coeure mentioned Brunnermeier's concept at a speech at Harvard University, as one way forward for the region.

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Here's how it works: A designated public or private institution buys the debt of euro-area governments. That task could fall to the private sector, or a European agency like the ESM...or even the ECB. That body would then repackage those bonds into a security with very safe (senior) and less safe (junior) slices, and sends the corresponding products off into the world.

As countries continue to issue their own bonds, and there are no guarantees involved, there's no mutualization of liability across countries, Brunnermeier explained in an interview in Frankfurt. That helps it clear the political hurdle at which previous suggestions, like Eurobonds, fell.

The point is that with such a system, investors can buy into the euro area as a whole, rather than into one particular nation. That would, in theory, stop capital fleeing to the safest (say, German) debt at the first sign of trouble. It would also help break the link between government fiscal policy and the health of their domestic banks.

> *"Now, when there is flight to safety, it goes across borders," Brunnermeier says. "In this arrangement, you will see re-channeling of the flight to safety that goes to senior from junior tranches and hence stabilizes periphery yields."*

Brunnermeier has been shuttling around drumming up support for the idea. He presented the plan on the sidelines of last month's annual meetings of the International Monetary Fund in Washington, D.C., and he plans to send out questionnaires to market participants across Europe to gauge interest.

The system's inventors admit that it is complex. And there's no guarantee of acceptance by the market, let alone by governments who may have interests in maintaining the status quo. Yet Brunnermeier and his colleagues have identified a grand bargain that could be made: Europe's periphery gets a debt instrument with greater credibility, and Germany gets a system that still takes account of sovereign risk.

"Somehow, that bargain needs to be struck," Brunnermeier says.

"The Euro and the Battle of Ideas," by Markus Brunnermeier, Harold James and Jean-Pierre Landau, was published in August by Princeton University Press