ESBies: A realistic reform of Europe's financial architecture

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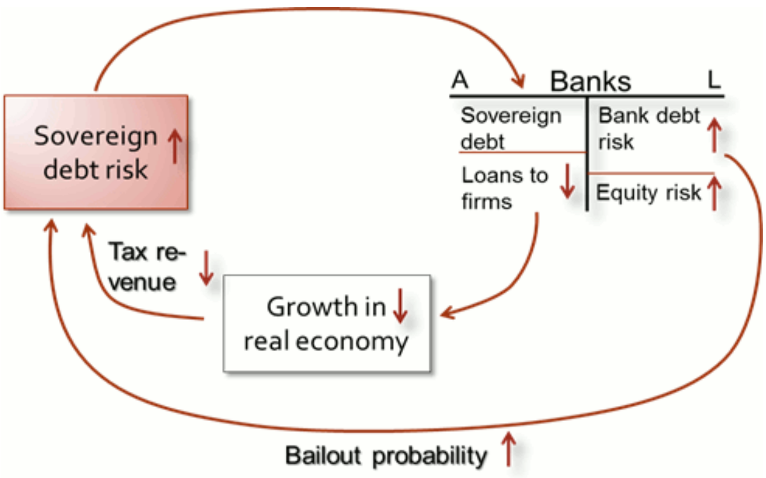
How can Europe fix its sovereign-debt crisis? Many favour euro bonds, but those seem politically impractical because they would require supranational fiscal policies. This column proposes creating safe European assets without requiring additional funding by having a European debt agency repackage members' debts into `euro-safe-bonds'.

The current European crisis has exposed several flaws in the design of the Eurozone financial system. It was internally inconsistent. On the one hand, it imposed a 'no-bail out clause' ruling out any bailout to ensure that interest rate differentials provide a clear signal about the buildup of imbalances. On the other hand, Basel bank regulations treated sovereign debt essentially as risk-free, implicitly assuming that there would always be a bailout. The latter assumption induced European banks to take on excessive exposure to their own sovereign credit risk. This led to a diabolic loop whereby sovereign risk and bank weakness reinforced each other – in countries where sovereign debt was perceived to be riskier, bank stocks plunged, leading to expectations of a public bailout, further increasing the perceived credit risk in government bonds, as illustrated in the following figure.

Figure 1.



Moreover, the current design of the Eurozone promoted excessive capital flows across borders, followed by massive self-fulfilling flight to safety when confidence in a given country's debt is lost. At times of turbulence, investors run from some countries, such as Italy, to park their investment in safe havens, such as German bunds. Seeing their bond price collapsing, these countries have to tighten their budgets, but insofar as this leads to contraction of their economies it validates the market's pessimistic expectations. In the run-up phase, capital flows from Germany into the peripheral countries were excessive, depressing German GDP growth for a decade. All in all, the diversity and cross-country allocation of sovereign bonds made the Eurozone's financial system unstable and led to the current crisis.

Many analysts, commentators, and policymakers view euro bonds as a solution to these problems. Euro bonds help to reduce the close ties between banks and their own country's sovereign risk, since they make all banks exposed to the same Eurozone-wide risk. Moreover, this risk is lower than in individual bonds since euro bonds enjoy the benefit of diversification. Also, euro bonds break the vicious circle of flight to quality. Finally, euro bonds will be easy to sell – the global demand for safe assets is very high. Many believe that the quasi-monopoly enjoyed by US Treasuries attracted global savings, which in turn made its way to subprime mortgages with well-known consequences. By creating a large-size alternative to US Treasuries, euro bonds will therefore provide stability to the world financial system.

Unfortunately, euro bonds are not politically feasible in the near future. Because they would involve joint and several liability of all member states, euro bonds cannot be set up without a common fiscal policy. National parliaments would be stripped of their most essential function – voting on fiscal policy. Government budgets, before even being discussed by elected representatives, would have to win the approval of a supranational committee where fiscally virtuous countries would have a decisive vote. Spanish fiscal policy would be partly decided in Brussels. This risks sharply reducing the democratic legitimacy of the European project.

Our proposal, Euro-Safe-Bonds (ESBies), has all the advantages of euro bonds (financial stabilisation of the Eurozone), without its drawbacks (political constraints).[1] ESBies are politically feasible because they involve no joint liability of member states. They imply no change in European treaties. Yet they will generate a very large pool of homogenous, safe assets that can serve as investment vehicles for global investors and reliable collateral for European banks.

Here is our proposal. A European debt agency would buy on the secondary market approximately 5.5 trillion euros of sovereign debt (60% of the Eurozone's GDP). The weight of each country's debt would be equal to its contribution to the Eurozone's GDP. Hence, each marginal euro of sovereign debt beyond 60% of GDP would have to be traded on a single bond market, where prices would reflect true sovereign risk, sending the right signal to the country's government. To finance its 5.5 trillion purchase, the debt agency would issue two securities. The first security, the ESBies, would be senior on interest and principal repayments of bonds held by the agency. The second security would receive the rest – it is therefore riskier and would take the hit if one or more sovereigns default. European banking regulation and ECB policy would be adjusted so that banks face incentives to invest in safe ESBies instead of risky sovereign debt.

According to our calibrations, this mechanism would allow the European debt agency to issue about 3.8 trillion of extremely safe ESBies. Given historical data and conservative assumptions about default correlations, ESBies would default once every 600 years. They would therefore be rated AAA and command a yield similar to (or even below) German bunds. The junior tranche, about 1.7 trillion euros, would yield about 6% in normal times and would be considered investment grade. Institutional investors as well as mutual funds and hedge funds would therefore be willing to buy it.

ESBies have many of the advantages of euro bonds. They create a large pool of safe assets, about half the size of US Treasuries, and will therefore stabilise and diversify global capital flows. If, as we propose, ESBies are accepted as collateral by the ECB (they are very safe), European banks will buy them. This will lower the exposure of banks to their own sovereign and break the vicious circle described above. ESBies will bring stability to the financial system. Yet they are politically feasible – because they are a pure repackaging of existing debt, they do not require additional funding by member states. They do not involve joint liability; if one member-state defaults, the junior tranche will take the hit. Finally, because purchases by the debt agency are capped at 60% of the Eurozone's GDP, countries will face their individual credit spreads on all euros borrowed above this limit. Individual market signals will discipline each government. Because they take moral hazard issues seriously, ESBies will not face opposition from public opinions in fiscally responsible countries. No new treaty will need to be ratified.

ESBies are a realistic and feasible proposal to improve the resilience of the Eurozone's financial architecture. They are part of the solution to the current crisis, but they are not the full solution. Getting out of the crisis also requires a combination of sovereign default and bank recapitalisations. Nor are they the only reform needed to stabilise the Eurozone's financial system in the medium run.

Hence, ESBies should be implemented along with new European-wide resolution mechanisms for bank failures and sovereign defaults, which we will describe in future papers. The good news is, they are easy to implement and will not face political opposition.

--Markus K Brunnermeier, Luis Garicano, Philip R Lane, Marco Pagano, Ricardo Reis, Tano Santos, Stijn Van Nieuwerburgh, and Dimitri Vayanos

References

Brunnermeier, Markus K, Luis Garicano, Philip R Lane, Marco Pagano, Ricardo Reis, Tano Santos, Stijn Van Nieuwerburgh, and Dimitri Vayanos (2011), "European Safe Bonds: ESBies," Euronomics.com

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[1] See Brunnermeier *et al* (2011) for a detailed description of the proposal.

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Tags: eurozone, sovereign debt, Eurozone crisis, euro bonds