

Can the eurozone countries still live together happily ever after?

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1. The problems

After the Greek public debt crisis and the bilateral loans to Greece from the other members of the European Monetary Union (EMU), in May 2010 the Ecofin Council launched the *European Financial Stabilization Mechanism* (EFSM). In June of the same year the EMU countries instituted the *European Financial Stability Facility* (EFSF). These two mechanisms, which are charged with providing support to EMU countries in “exceptional difficulty”, received their baptism of fire with Ireland in January 2011 and successfully made their first bond issue on the market.

In conjunction with the declarations in favour of the euro by German Chancellor Angela Merkel and French President Nicolas Sarkozy in Davos, the success of the issue stemmed the immediate risks of contagion and temporarily relieved the speculative pressure on European sovereign debt securities. With the partial exception of Ireland, between mid-January and the first few days of February the peripheral EMU countries saw the spreads on their government bond yields over those of Germany narrow (see Figure 1) and their credit default swap premiums diminish (Figure 2). And although the German proposal to link sovereign debt management and fiscal and

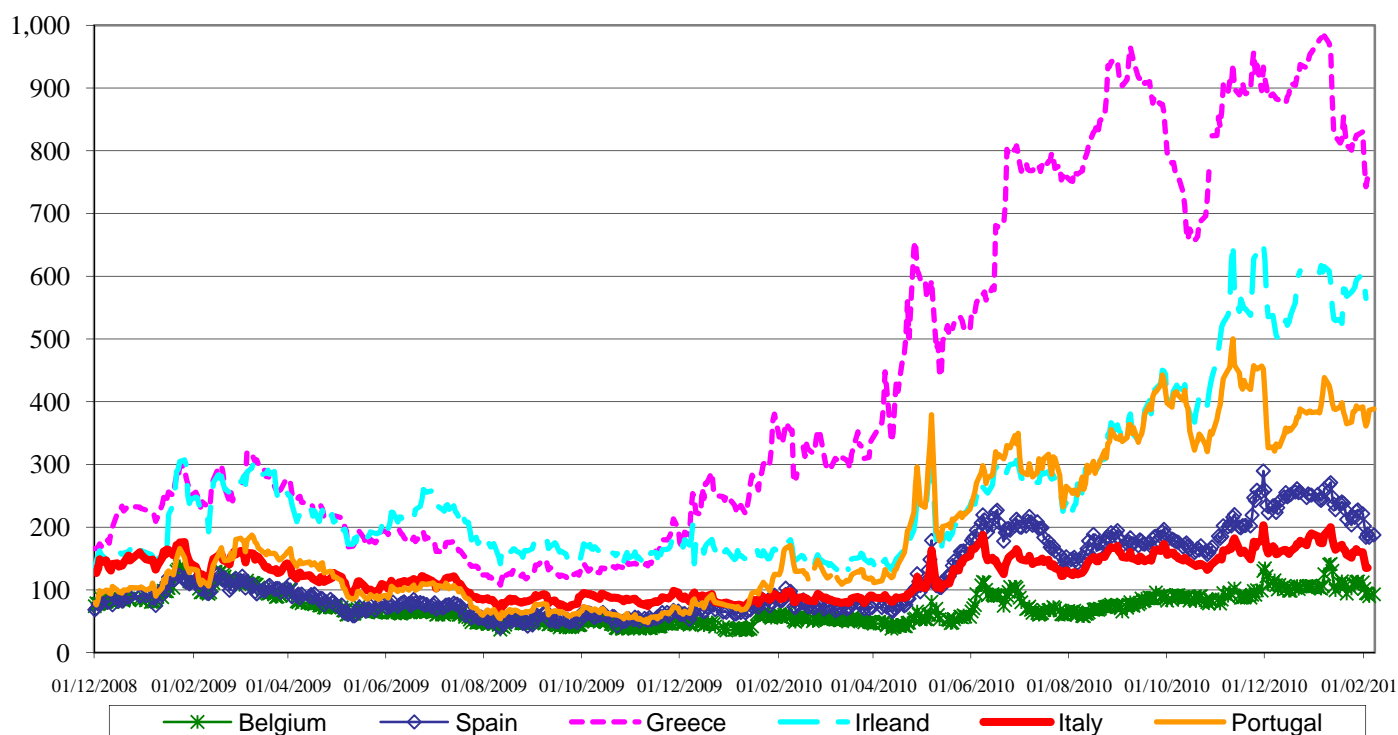
macroeconomic coordination was met with a cold reception from several member states at the latest European Council meeting (on 4th February), the forthcoming meetings of the heads of state and government of the EMU and of the Eurogroup and the end-March European Council session promise to impart new impetus to sovereign debt management, the revision of the Stability and Growth Pact and the setting of macroeconomic competitiveness standards within the EMU.

The solution of Europe’s sovereign debt problems cannot, however, be entrusted to the two stability funds, not even in tandem with the International Monetary Fund. The EFSF, the larger of the two, is not internal to the EMU but is an autonomous, special vehicle guaranteed on a proportional basis by the non-user member states. It can only intervene within the limits of Article 122 of the European Treaty – that is, only if a country is in difficulty due to exceptional reasons beyond its control – and without purchasing public debt securities. Furthermore, EFSF support will end in June 2013 when it will be replaced by the new European Stability Mechanism (ESM), approved by the Eurogroup at the end of November and by the European Council in December.

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Figure 1. Government bond spreads



Source: Author's elaboration

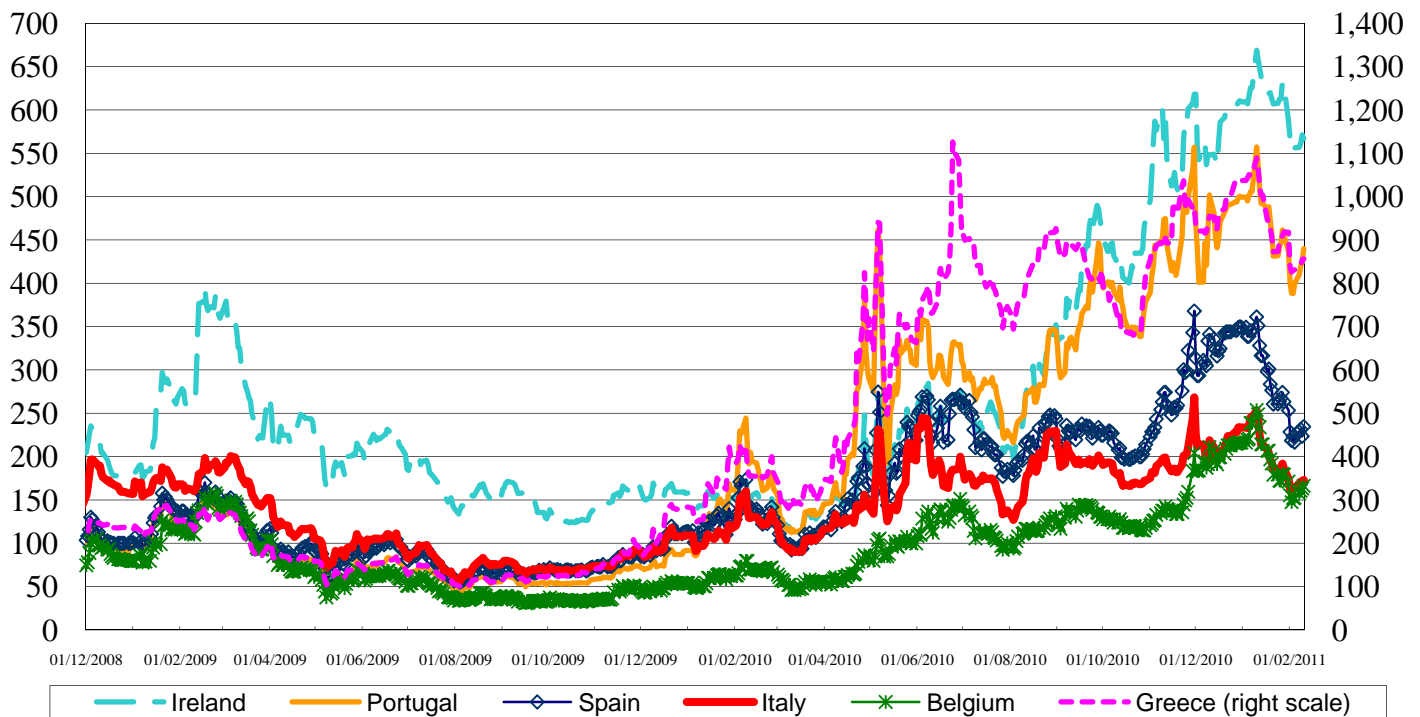
But the ESM too appears inadequate to deal with the problems of European sovereign debt. Although ESM is a permanent crisis-management mechanism and instituting it required a Treaty amendment, it looks to be modelled on the EFSF and to partake of or even to magnify many of its precursor's limitations. The ESM's field of action and organisational structure have yet to be defined in detail. As things now stand, notwithstanding the European Central Bank's opinion to the contrary, it too will probably lack a mandate to purchase member states' public securities.¹ Like the EFSF, the ESM will intervene to support EMU members in

difficulty for exceptional reasons, but unlike its predecessor, its loans will have seniority over any private creditor position and will thus tend to provoke crowding-out effects on private investments in sovereign bonds. In addition, the ESM will set the conditions for support to countries in difficulty and the degree of 'punishment' to be meted out to private sector investors in those countries' public bonds case by case, with extremely wide discretion and highly complex decision-making processes. Consequently, it will probably be condemned to carry out only emergency interventions, with maximum costs to providers and recipients alike.²

¹ The European Central Bank risks remaining the sole European institution to buy public debt securities of the peripheral EMU countries. It made its first purchases in concomitance with the bilateral interventions in favour of Greece, thereby aggravating the deterioration in the quality of its balance sheet assets that had resulted from its generous open-market operations in support of the European banking sector since the initial phases of the financial crisis.

² Amato et al. (2010) paint a more positive picture of the ESM, which they liken to a *European Monetary Fund*. On the other hand, Gros (2010) stresses that the seniority of the ESM's claims sends a distortionary signal to the market in that it aggravates the risk of default on private claims with respect to the sovereign debt of the peripheral countries. This explains the possibility of crowding out.

Figure 2. Credit default swap (Cds) premiums



Source: Author's elaboration

The current debate among the EMU member states, focusing on whether or not to raise the EFSF's potential lending ceiling,³ does touch on important points to stem the crisis in the short run. But it offers no structural solution to the European sovereign debt problem. Such a solution would have to rest on at least three components: i) the creation of a European Debt Agency (EDA) within the EMU that supersedes the EFSF and ESM and buys member states' government securities, enabling the European

Central Bank to free itself from its inevitable but improper stand-in role (see footnote 1); ii) the involvement of all the EMU countries in providing a comprehensive joint guarantee on the bonds issued by the EDA;⁴ iii) the setting of systematic rules and, when possible, market rules for the organisation of the EDA's transactions. Plainly, putting these elements in place would create a market for European public bonds (*eurobonds*).

³ In principle, the EFSF can issue up to €440 billion of liabilities, covered by a guarantee of the same amount allocated pro rata among all the EMU countries. But since only some member countries have AAA ratings and Greece and Ireland are excluded as direct or indirect beneficiaries of European financial support, reliable estimates put the EFSF's effective lending capacity at under €300 billion. The member states are debating whether the pro rata guarantee ought to be increased to give the facility an effective lending capacity of €440 billion or even more. Meanwhile, the Eurogroup meeting of 14 February decided that the ESM's initial operations (June 2013) will have an effective lending ceiling of €500 billion, subject to review every two years.

⁴ As Favero and Missale (2010) point out, unlike a pro rata guarantee, a comprehensive joint guarantee aligns the valuation of the counterparty risk with the prevailing valuation for the corresponding securities issued by the 'strongest' guarantor. In the case in question, the valuation of the new European public debt securities should therefore be aligned with that of the corresponding German securities. This point is disputed by commentators who insist on the close correlation of sovereign debts in the peripheral countries. Nevertheless, empirical evidence shows that it is well within the capability of the EMU countries that have a triple-A rating to provide a comprehensive joint guarantee for all the public securities of the peripheral countries. Whether this is politically viable is another question (see Section 3).

2. A new solution

Even if we consider the output of just the last few months, the literature on eurobonds is abundant.⁵ Here I draw on various proposals, selecting the elements that are consonant with the solution I intend to construct.

The European Debt Agency can issue European sovereign debt securities worth up to 60% of the EMU's GDP, so that its liabilities do not infringe the parameters of the European Stability and Growth Pact. These securities are fully and jointly guaranteed by all the EMU member states. With the full and joint guarantors including the countries that have a triple-A rating (Germany first and foremost), the EDA, unlike the EFSF, can attain its maximum issuance potential since it does not have to resort to over-collateralisation in order to place its securities at market conditions in line with those of the 'strongest' EMU countries (see footnote 4). The EDA uses the resources so procured to purchase the debt securities of the individual EMU member states that elect to avail themselves of this opportunity. This presupposes the amendment of Article 125 of the European Treaty, which prohibits all bail-outs among the countries of the European Union. The supply of securities of the member states may come from two possible sources: the flows of the countries that prefer to resort to the EDA rather than to tap the market for new issues, and (part of) the stock held by investors who are ready to sell at a given price.

⁵ See, among others, De Grauwe and Moses (2009), Delpla and Weizsäcker (2010), Gros and Mayer (2011), Juncker and Tremonti (2010), Messori (2010), and Monti (2010a and 2010b). Gianviti et al. (2010) have developed a different solution to the European sovereign debt problem. They propose creating a *European Crisis Resolution Mechanism* to restructure the debt of EMU countries found to be insolvent or on the verge of insolvency. Restructuring, agreed between the debtor country and its creditors, would be intended to restore the solvency of the country's sovereign debt and commit the country to fiscal discipline in the future in exchange for financial assistance from other member states. The complex restructuring procedures would be handled by the Court of Justice of the European Union.

To obviate the need for the EDA to equip itself with the 'technologies' to operate in the retail markets, each member state is assumed here to act as intermediary for the transactions involving stocks of its own sovereign securities. Further, the actual price at which a country's securities are sold to the EDA is equal to the price at which that country buys back the stock of its own securities. These two assumptions, which preclude shifting (part of) the cost deriving from the discount at which the securities are sold to the EDA from the member states onto investors, mark a difference between our proposal and that of Gros and Mayer (2011). The latter envisages a complex procedure for renegotiation between the European agency, whose direct purchases include purchases from the privately-held stock, and the member states in difficulty.⁶ The renegotiation, which does not apply to private creditors, makes it possible to mitigate the haircut for countries ready to undertake a fiscal consolidation programme. It should be noted, finally, that the approach proposed here also assumes that the maximum demand price (p_d) set by the EDA for member states' securities coincides with the price at which its eurobonds are placed on the market.

In 2010 the debt/GDP ratio of the EMU countries averaged about 84%. Consequently, the potential demand for member states' securities from the EDA, whose ceiling in value is 60% of the EMU's GDP, is lower than the maximum potential supply. On the other hand, for the reasons already given, the EDA is able to place its own securities on far better market terms than the weaker EMU countries. This is an ideal situation for organising the transactions between the EDA and the member states through the mechanism of the "non-uniform price reverse auction". For the sake of simplicity, in what follows it will be assumed that each EMU country issues only a single type of public debt bond. This simplification is justified by the considerable standardization of the national markets in government securities within the EMU.

⁶ Another important difference is that in Gross-Mayer proposal purchases are limited to countries already financed by the EFSF or about to be. This explains why it is assumed that the transactions are conducted at the pre-crisis market prices of those countries' government securities.

Moreover this hypothesis could be refined, without undue complication, by assuming that a single linear vector of public debt securities is issued.

The EDA opens the auction, setting the maximum quantity (Q_d) and maximum price (p_d) of its demand for member states' bonds, p_d being equal to the market price of its own eurobonds. Each of the 17 EMU countries that wants to sell its newly issued bonds to the EDA and/or has signed buyback contracts with the holders of the stock of its bonds that are contingent on the success of its participation in the reverse auction simultaneously sets the minimum price (p_s^i ; where $i=1, 2, \dots, n$; with $n \leq 17$) at which it is willing to sell those bonds and the quantity offered (q_s^i). Obviously, participation in the auction requires $p_s^i \leq p_d$. However, it is possible (and probable) that at the n supply prices thus set, the quantity of bonds offered will exceed the EDA's predetermined maximum demand (that is to say $\sum q_s^i > Q_d$). If this is the case, the order of access to transactions with the EDA is inverse to the supply price set by each of the n member states. In other words: the country that set the lowest price is the first to sell to the EDA the desired quantity offered at the price it has set. The auction ends when the actual transactions reach the maximum quantity that the EDA has undertaken to demand. The last country to have access to transactions with the EDA is thus the one to get the highest price, but it is at the risk of not selling the entire quantity offered. Countries that have set even higher supply prices are closed out.

Thus, the member countries' participation in the reverse auction is voluntary, but, assuming rational behaviour, the auction design is extremely attractive for all the peripheral countries that the markets deem to be illiquid or even on the brink of insolvency, but not for the 'strong' countries. The latter countries and the holders of their securities will decline to apply any discount or anything more than a symbolic discount to the supply price of these securities with respect to the market price (p_d) of the eurobonds. Consequently, the peripheral countries and the holders of their securities can crowd out the securities of the stronger countries and have a very good chance of transferring all their sovereign debt to the EDA at a modest, though more than symbolic, discount to the

supply prices of their securities. The "non-uniform price reverse auction" will thus make it possible to sell the peripheral countries' public securities to the EDA at prices not much lower than those obtained before the illiquidity or quasi-insolvency crisis. In other words, it will permit a restructuring of the sovereign debt of the peripheral countries of the EMU at a 'moderate' cost.⁷

A simple empirical check allows us to sharpen and strengthen this conclusion. The data on public debt and GDP in the EMU show that if the EDA immediately set the amount Q_d at its ceiling (that is, given p_d at a level corresponding to the 60% of the EMU's GDP), it could readily absorb the entire end-2010 stock of public debt securities of the member states rated lower than AAA, plus all their new issues planned for 2011 and 2012. Alternatively it could almost be in a position to purchase the entire end-2010 stock of public debt securities of all the EMU countries except Germany (see Table 1). This implies that, in principle, all the peripheral countries could sell the entire stock of their sovereign debt to the EDA at prices not too squeezed by competition. In particular, each of the member states with illiquidity problems or on the brink of insolvency would apply that discount to the supply price of its securities, which narrows the current spreads of its public bond yields over those of Germany but, at the same time, minimizes the probability of being (even partially) left out of the reverse auction.

⁷ Darvas et al. (2011) propose a different way of restructuring European sovereign debt at "moderate" cost. The starting point of their analysis is the interdependence between the severe balance sheet problems in part of the European banking sector and the sovereign debt crisis, and therefore involves a larger set of variables. It would be interesting to see if the reverse auction mechanism described here can be incorporated in this more general and even harder-to-execute approach.

Table 1.

Country	Public debt/gdp 2010	Country public debt/ total emu debt (2010)
Euro area	84%	100%
Germany	76%	24,58%
Euro area - 'AAA' countries	76%	54,64%
Austria	71%	2,57%
Finland	50%	1,15%
France	84%	21,22%
Luxembourg	20%	0,10%
Netherlands	66%	5,02%
'AAA' countries without Germany	76%	30,06%
Belgium	100%	4,57%
Cyprus	61%	0,14%
Estonia	8%	0,01%
Greece	134%	3,97%
Ireland	93%	1,89%
Italy	119%	23,79%
Malta	67%	0,05%
Portugal	83%	1,83%
Slovenia	34%	0,15%
Slovak republic	42%	0,36%
Spain	63%	8,60%
Euro area - non 'AAA' countries	96%	45,36%
Euro area without Germany	85%	75,42

Source: Eurostat.

3. Why would Germany agree?

Table 1 highlights at least two advantages of the reverse auction mechanism described here. Unlike the proposal put forward by Depla and Weizsäcker (2010), it does not limit the peripheral EMU countries to converting only some of their securities ('blue bonds') into eurobonds and require them to hold their remaining securities ('red bonds') in the old national form. The separation of blue from red bonds would segment the financial markets and in the end merely alter the composition of European sovereign debt (Gros, 2011). In the reallocation, for most of the peripheral countries the gains from the blue bonds (lower interest rates and reduced illiquidity and default risks) could easily be more than offset by deterioration in the standing of the red bonds. Moreover, with the reverse auction mechanism and, given the size of the public debt within the EMU, the

peripheral countries and their bondholders will be subjected to modest and converging haircuts, sufficient to curb moral hazard but not lapsing into the mystique of 'punishing' rash private investors (De Grauwe, 2011).

This plan will thus apparently let the EMU countries 'live together happily ever after' even though - unlike many fairy tales and some policy proposals - it avoids unrealistic provisions for a free lunch. But to specify the actual functioning of the "non-uniform price reverse auction", a series of other crucial questions need to be answered. The three most important may be: what to do with the profits that the EDA will inevitably earn by reason of the positive if modest spreads between the market price of European sovereign debt and the auction prices of the peripheral member states' bonds? What reason would Germany have for offering a comprehensive guarantee for a mechanism that it is most unlikely ever to use?

And what would keep the peripheral countries, once they have transferred their previous public finance imbalances to a European agency, from again behaving as de la Fontaine's *cigale* and thus becoming a source of instability?

The best answer to the first question is that the EDA should channel its profits, after its operating costs and its transaction costs, to a fund for European tangible and intangible infrastructure.⁸ The alternative espoused by Gros and Mayer (2011) – returning at least a part to the member states that ‘punished’ investors by setting a low price for selling their paper to the EDA and that agree to a fiscal consolidation programme – would create distortions in the reverse auction framework itself. And as our third question also highlights, it fails to resolve the problem of providing an incentive for the peripheral countries to share a set of fiscal and macroeconomic policy rules compatible with growth.

The second question goes to the heart of the matter, raising again the problem of fiscal discipline, but from a different angle. In fact, the comprehensive joint guarantee offered by the strong members that underpins our reverse auction framework requires Germany to take on a good portion of the weaker members’ fiscal risk, with no evident benefits in return. I do not presume to prove conclusively that this is not so. But I shall name six likely advantages for Germany in the conversion of peripheral countries sovereign debt into eurobonds.

First: This conversion would create a large market for European sovereign debt securities, which, suitably combined with the market for German Bunds, would reduce liquidity risk within the EMU and enhance the euro’s international role, giving Germany leadership of a currency area strengthened as a world player. Second: The comprehensive joint guarantee for EDA issues would align the new European bonds’ rating with that of the German Bund, thus relieving the European Central Bank of the burden (borne unwillingly by German policy-makers) of buying the public debt of the

peripheral members and loading up its balance sheet with high-risk assets. Third: the modest haircuts applied to the peripheral countries public securities would have a tolerable impact on the balance sheets of the German and other European banks which hold a large amount of these securities, thus eliminating the need for new and costly state interventions. Fourth: resolution of the acute aspects of the sovereign debt crisis would end the need for ad hoc interventions in support of EMU countries on the brink of insolvency, which are costly for all EMU members, including Germany. Fifth: this would also ease the recession in the weaker countries, and facilitate those structural reforms at national level that are essential to attenuate the worst intra-EMU imbalances and so strengthen Germany’s role as leader of an economically dynamic area. Sixth, and crucially: combined with suitably reformed European governance, the EDA could give Germany a decisive say in setting the new rules for the EMU and EU.

All that needs be done to implement this last point is to give each member state powers of decision in inverse proportion to the volume of public debt that it sells to the EDA. Thus, if Germany were the only large country not to convert its public debt securities into European debt, its leadership would stand fully acknowledged. Besides, this leadership could be exerted on the crucial components of EU’s new governance: the revision of the Stability and Growth Pact, the definition of macroeconomic coordination standards within the Union, and the working of the micro-prudential and macro-prudential supervision at European level.

The strengthened German leadership in the new European governance points to an answer to our third question. In this way EMU’s peripheral countries would credibly demonstrate their acceptance of fiscal and macroeconomic discipline; and, on the other hand, Germany would not be forced to go too far in setting its desired European discipline standards just for bargaining reasons. Moreover, the reverse auction mechanism and the EDA’s ceiling (that is, the 60% of the EMU’s GDP) would remain operative through time so that the peripheral countries would have to limit their future issues of securities to avoid either an increase in the discount to the supply prices of these securities,

⁸ The idea of eurobonds to fund infrastructure construction goes back to the Delors Committee in 1993. It has been taken up again recently by Monti (2010a) and Amato et al. (2010).

or an increased probability of being left out of the reverse auction.

The framework set out here would enjoy the twofold advantage of dispensing with any distortion-inducing linkage between the formation of the peripherals' bond prices and the design of reliable mechanisms for macroeconomic and fiscal discipline, while at the same time safeguarding strict linkage on the plane of effective realization. On the other hand, by entrusting discipline to governance mechanisms, this framework would maintain a degree of flexibility to prevent macroeconomic and fiscal coordination from turning into an insurmountable obstacle to the growth of EMU's peripheral countries.

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