Jakob von Weizsäcker
Head of Department
Thuringian Economics Ministry

# Blue Bonds Reconstructed

The desirability of the introduction of eurobonds continues to be the subject of a spirited debate in economic policy circles against the backdrop of the ongoing euro crisis. This debate is complicated by the fact that various eurobond proposals with different characteristics have been made. As a result, when the subject is being discussed in the public arena, proponents and critics are routinely not even talking about the same thing. Because the details of these different proposals matter, I was delighted to present the details of one such scheme, namely *The Blue Bond Proposal* co-authored with Jacques Delpla, on the occasion of the 2012 annual conference of the Oesterreichische Nationalbank. Drawing on our original publication[1], the present exposition takes particular care to reconstruct our Blue Bond Proposal, using the basic eurobond concept as a starting point.

## 1 The Basic Eurobond Concept

The natural starting point for a discussion of eurobonds is its simplest and cleanest variant, namely the pooling of the entire government debt of the euro area to be jointly and severally guaranteed by participating countries. The advantages are obvious: it would create a homogenous and highly liquid asset on par with US government debt, thereby reducing funding cost and further promoting the use of the euro as an international reserve currency. Also, the risk of destabilizing flight to safety phenomena which are currently fuelling the crisis loop between sovereign debt and financial institutions would disappear. Finally, it would reduce the currently experienced pressures on the ECB to stretch its institutional mandate and legitimacy to engage in the kind of heavy lifting for which the ESM/EFSF lack size. But the disadvantage is equally obvious: the joint guarantee for government debt underlying the basic eurobond stands to create massive problems of moral hazard. In particular, borrowing costs would become identical for all participating countries irrespective of their particular fiscal stance and credibility.

One way to address such moral hazard problems is rules based, installing institutional safeguards against excessive borrowing. Examples of this type of arrangement at the European level are the Maastricht Treaty with the no-bailout clause and the Stability and Growth Pact and, more recently, the Fiscal Compact with an emphasis on domestic debt brake arrangements. Such rules may either ban certain levels of deficit or debt for good, or – perhaps less draconian – administratively impose higher borrowing costs (which may or may not be called fines) on countries following a somewhat reckless fiscal path. However, such arrangements, while helpful, may have credibility limits even for today's purposes,

[1] *Delpla, J. and J. von Weizsäcker. 2010.The Blue Bond Proposal. Bruegel Policy Brief. May.*

let alone with eurobonds where moral hazard issues would be more severe.

This is the fundamental reason why we prefer a more complicated design for eurobonds where the present rules based discipline is complemented by market based discipline for borrowing at the margin.

## 2 Two-Tier Structure: Blue Bonds and Red Bonds

With this objective in mind, one immediately arrives at the two-tier structure which is at the core of our proposal. Intra-marginal borrowing is to take the form of eurobonds with joint-and-several liability which we call Blue Bonds. And borrowing at the margin is to take place in much more expensive Red Bonds with purely national responsibility for those amounts borrowed.

This divide into two tiers of debt immediately raises the question how Blue and Red Bonds will be kept apart legally and in practice. Legally, it is important that Blue Bonds would have senior status while Red Bonds only have junior status so that the part of national debt for which the euro area partners have given their guarantee will always have to be serviced fully before any national Red Bonds are serviced to avoid free riding. But beyond this legal safeguard it would also make sense to back up this arrangement institutionally by means of a centralised European Debt Agency that would issue all debt of participating countries, Blue and Red, which would greatly help to assure compliance with the rules of the system in practice, including the seniority of Blue Bonds.

With the two-tier structure, another crucial issue arises, namely that of the diving line between Blue and Red debt. How much Red and how much Blue debt should any participating country be allowed to issue? In order for the system to be credible, the Blue debt should not exceed the limit generally deemed to be safe within the general framework of the euro area which is 60% of GDP according to the Maastricht Treaty. While this exact threshold is not rigorously founded in economic theory, it would appear to be unwise to deviate from this well-established upper limit without powerful economic evidence to the contrary. Also, within this limit, the Blue Bond market would already be sufficiently substantial (EUR 5 to 6 trillion) to be on par with the US Treasury bond market (roughly EUR 7 trillion) in terms of liquidity.

This then raises the question whether any participating country should be allowed automatically to borrow up to that 60% limit in Blue Bonds. In our proposal, we opt against such an automatic mechanism for two reasons. First, we think that the quota allocation in Blue Bonds could and should be used as an additional disciplining device to fight moral hazard, including the possibility of gradually phasing out the Blue borrowing of a country if persistent and serious concerns about the sound-

ness of economic and fiscal policy of the country in question were to arise. Second, we believe that parliamentary control of Blue borrowing should remain an integral part of the system to assure regular and continued democratic control. Blanket joint-and-several guarantees for Blue Bond borrowing up to 60% would severely undermine this parliamentary budget authority. This is also the fundamental reason why a gigantic blanket guarantee without this regular parliamentary control would unlikely to be constitutionally acceptable in a country like Germany.

## 3 Independent Stability Council

But how could the decisions on the annual Blue borrowing quotas with their corresponding joint-and-several guarantee for participating countries by all the national parliaments involved be organised in practice? Without any clear institutional structure to prepare this decision, it could turn out to be a politically messy affair with market confidence in the entire scheme at risk. To resolve that issue, we argue in favour of the creation of a independent stability council with members of impeccable expert standing and a high degree of independence in ways similar to the board of the ECB. This stability council would annually make a proposal for the allocation of Blue borrowing quotas rewarding sound fiscal management and taking macro-risks into account. This proposal would then be put to vote in the national parliaments of all participating countries as a take-it-or-leave-it proposal.

Any country voting against the proposed allocation would thereby decide neither to issue any Blue Bonds in the coming year nor to guarantee any Blue Bonds of that particular vintage. Since the decision of any major participating country to ease itself out could undermine confidence in the entire scheme, the independent stability council would have a strong incentive to err on the side of caution, thereby safeguarding the interests of the European taxpayer.

Also, to protect the European taxpayer further, it would be important to enshrine the institutional set-up of the Blue and Red bond scheme within a solid treaty framework, not least the critical 60 percent GDP limit for Blue borrowing. The disadvantages in terms of time and effort required by major treaty change would in our view be outweighed by the extra credibility and democratic legitimacy that would come with such a "Blue Treaty".

## 4 Credible No-Bailout Clause for Red Bonds

But all of these arrangements to make this critical two-tier structure work in practice only make sense if the reinforced no-bailout clause for Red Bonds became fully credible. If it were felt that a default on Red debt could result in severe financial contagion, it might well be that Red debt would in future crisis be bailed out regardless, just like Greek government bonds in 2010. While Basel III has increased the capital requirements in Banks for government debt as well as capital buffers overall, we have doubts whether these improvements to the stability of the banking sector alone would make the no-bailout on Red debt fully credible. Therefore, we propose a more drastic measure of squeezing the Red debt out of the entire banking system through regulatory means. Specifically, Red debt as opposed to Blue debt would not be eligible for ECB refinancing operations and Banks holding Red debt should be confronted with painful capital requirements. As a result, holding of Red debt would be concentrated with investors

who would generally have much better loss absorption capacity than banks if and when problems with Red debt were to arise.

## 5 Crisis Mechanism

This leaves us with the question how Red debts could in the future be restructured in an orderly and credible manner in the event of a crisis while assuring the funding of short term primary deficits and rolling over the debt stock. To address this, we suggest relying on the ESM in crisis times. But, as outlined in the following, the ESM could be much leaner and more focused in the arrangement we propose. The reason is that Blue debt could simply be rolled over within the framework of the Blue bond system. As for Red debt, we propose a specific type of automatic restructuring triggered if and when an ESM programme is activated. For the duration of such an ESM programme, the coupon on the Red debt of the programme county would be automatically suppressed and the maturity lengthened for the period that the programme persists. Because this clause would already be included in each and every Red Bond contract ex ante, this restructuring would not even constitute a default event. Since no roll-over or interest on Red debt would fall due during the ESM programme, all that would remain for the ESM to cover would be the primary deficit of a crisis country plus interest payments on outstanding blue debt. The current size of the ESM would probably be sufficient as it would leverage itself not through the ECB with a banking licence but through a seamless interaction with the Blue and Red Bond scheme.

## 6 Transition Regime

Having outlined how the proposal – once fully implemented – would have significant advantages in dealing with future crises, the final and arguably most pressing question arises whether the scheme could be of any help in addressing the present crisis. In particular, there is concern that the introduction of the Blue and Red debt divide might even further destabilise the current situation because Red debt interest rates would be sky high and crisis countries with their large debt overhang would be extremely unlikely to be able to borrow at all in Red debt in the current environment. For crisis countries suffering from solvency instead of mere liquidity problems, there is a straightforward answer to that concern: with the introduction of Blue and Red debt in exchange for legacy debt, a sizeable haircut to eliminate the debt overhang should be applied. If done properly, the potentially destabilising effect of the Red debt would be eliminated as well. Of course, this observation does not answer the question, which of the crisis countries are in fact insolvent and which are merely suffering from a liquidity crisis exacerbated by the resulting jump into a bad interest rate equilibrium which could be reversed with sufficient credibility and firepower of the support mechanism. However, this challenge is of course not specific to the Blue Bond proposal. And at least it creates a framework within which a somewhat bolder take on which crisis countries should be applying a haircut to their debt could be followed through, at least if complemented by an intelligently designed banking union, the very subject of other papers in this volume.