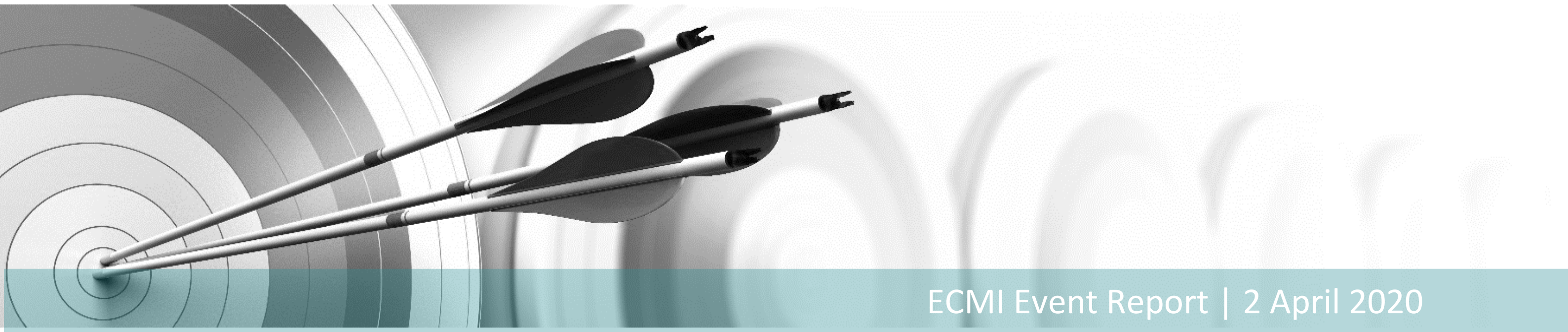

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Will COVID-19 reduce the resistance to eurobonds?

Apostolos Thomadakis*

With the spread of COVID-19 across Europe, governments and central banks are mobilising resources to avoid a deep recession, growing unemployment and corporate failures. The issuance of joint eurozone debt, or so-called eurobonds, could ensure the necessary fiscal resources to tackle the crisis. Are eurobonds a solution to the current challenges and how should such an instrument be designed? Who would issue the eurobonds and how would they be traded? Where would clearing and settlement take place? This webinar considered the practical aspects (and conveniences) of a common euro bond.

Speakers:

Vítor Constâncio, Former Vice President of the ECB, and current President at the School Council at ISEG, University of Lisbon
Maria Cannata, Chair of MTS Markets and former Director General of the Public Debt Directorate, Italian Treasury

Moderated by **Karel Lannoo**, CEO of CEPS and General Manager of ECMI

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The report is not a transcript of the speakers' interventions; rather, it should be understood as an interpretation of their views by the author.

Summary

While eurobonds have existed since the 1960s,[1] interest in them reignited during the sovereign crisis, but as real 'euro'-bonds. That was an effort to avoid countries losing access to markets, also in the future. The current systemic shock in Europe is a completely different situation.[2] The resources mobilised by governments and central banks in recent weeks are unlikely to be sufficient to avoid a deep recession, growing unemployment and corporate failures.[3] COVID-19 demands that the response be as big and far-reaching as possible. Under these circumstances, eurobonds could prevent countries from losing access to markets from increased deficits, and provide a common response to the crisis. In other words, eurobonds reflect the degree of solidarity among European countries and put them on equal footing to finance their needs.

Eurobonds have many advantages

Eurobonds, a form of mutualised debt, have several advantages.[4] First, the issuance (i.e. financing, access to the market) is not based on a sovereign credit rating. Currently, countries need to increase their deficits to address the health crisis and soften the economic shock. However, increased deficits will result in lower credit ratings and hinder access to markets. Thus, countries wary of that happening (e.g. Italy, Portugal, Spain) have put forward programmes that are lower (as a % of their GDP) than others.

Second, eurobonds would be available to all eurozone countries. However, ESM programmes would only be used by weaker countries, which carries its own stigma and sends a bad signal to the markets (which could potentially trigger rating downgrades). For this reason, ESM programmes do not appear to be attractive and countries are somewhat reluctant to follow that route.

Third, from a market perspective, eurobonds could be used by banks to diversify their portfolios away from domestic debt (i.e. breaking the bank-sovereign nexus), thereby releasing pressure on domestic banks.

Fourth, eurobonds would contribute to the integration of the European bond market – a core component of European capital markets – and foster the international role of euro.

Last but not least, eurobonds fulfil the characteristics of common social bonds following the United Nations (UN) principals and the Sustainable Development Goals (SDGs). The green market has developed considerable in recent years, so it may be the right time for Europe to have a social bond than can help us overcome this pandemic. Moreover, we should not overlook the impact that a common issuance of eurobonds would have on domestic markets. Such an announcement, as well as the commitment by a European institution, would result in the tightening of spreads, relieving

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[1] In 1963 the Italian Autostrade launched the first Eurobond listed at the Luxembourg Stock Exchange.

[2] Italy was the first country to be hit with significant effect. While the Italian experience can help other countries avoid/eliminate the uncertainties that characterised the response at the start of the problem, it is not clear whether the Italian lesson has been learned by others.

[3] For an overview of policy responses see IMF: Policy Responses to COVID-19.

[4] Many different proposals have been put forward over the years, which differ not only in terms of schemes and legal forms (e.g. composition, guarantee, weighting), but also in the status of the bonds vis-à-vis the investors that will buy them, as well as in the use of the money. For an overview see: Claessens, S., A. Mody and S. Vallée (2012), "Paths to Eurobonds", IMF Working Paper, WP/12/172; and Delivorias, A. and C. Stamegna (2020), "Joint Debt Instruments: A Recurrent Proposal to Strengthen Economic and Monetary Union", April, European Parliament Research Service.

concerns about national public accounts, reducing market volatility, and reassuring international investors that there is a true European commitment.

... and disadvantages

Regarding the disadvantages of eurobonds, these are mainly seen from the perspective of the 'strongest' countries, which can currently issue at negative interest rates. Assuming that the eurobond would not have the same low level of interest rates, the proceeds would be used by all countries, according to the distribution rules that will be decided. This would imply that 'strong' countries would pay more for their part/contribution to the service of eurobonds than they currently pay for the national debt they issue. That in itself is a transfer, which makes them reluctant to accept the idea. Importantly, if all countries, one way or another, participate in the costs of servicing the eurobonds, then the contribution to the costs would be according to country size and importance in the European economy.[5]

Who would issue the Eurobonds?

The obvious question arises as to who would be best placed to issue eurobonds: the ESM, the Commission, or a newly created institution?

- The ESM has the available capital and the bonds to be issued would have AAA status.[6] However, according to its statue it can only provide assistance (i.e. loans) to countries that have no other resources and have lost market access (i.e. cannot refinance their debt by issuing bonds on the market). Therefore, and as described above, the fact that ESM loans carry a stigma and send a bad signal to the markets (triggering potential downgrades), make 'weaker' countries more reluctant to pursue this option. Instead, ESM would be best suited to provide services, such as preparing the issuance, placing the bonds on trading platforms for the secondary market, etc. In this way, it would no longer be any ESM programme; it would just be a service provided by the ESM.
- The Commission under Article 122(2) of the Treaty on the Functioning of the European Union (TFEU) may grant - under certain conditions – financial assistance to a member state(s).[7] This would allow the Commission to create a programme/fund and issue debt to be used for the current crisis.[8] Such a programme/fund – contrary to the announced new instrument for temporary Support to Mitigate Unemployment Risks and Emergency (SURE)[9] – would not provide loans to countries (thus increasing their debt), but rather would share the burden and take over the budget expenditures of member countries (e.g. with health or unemployment subsidies). The Commission has done this before as financial assistance to balance of

[5] However, if the funds obtained balance the countries' costs (as a % of GDP), there would be no further transfers (just the difference in interest rates). That depends on the distribution model to be decided. For instance, if the programme is related to health or employment, then the percentage and size of those expenditures in each country would be different and the transfers could (in some cases) be either way. This is part of the insurance concept behind the eurobonds.

[6] ESM bonds enjoy a triple-A rating, based on its €80 billion capital and on the 'joint and several' commitment of the member states.

[7] Article 122(2) of TFEU: "Where a Member State is in difficulties or is seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control, the Council, on a proposal from the Commission, may grant, under certain conditions, Union financial assistance to the Member State concerned.".

[8] Of course, countries would have to pay an additional contribution to the budget over the years to face the service of these bonds, as part of their commitment to the European budget.

[9] See President's Von der Leyen remarks on SURE.

payments (Balance of Payments Regulation) of European countries and it has also issued debt in order to fund that assistance.[10]

- Alternatively, a new legal framework could be created that still requires the involvement of an existing institution (e.g. ESM) to provide the operational/logistics services (e.g. organise the issuance and prepare trading). While the EIB has the knowledge and experience to monitor the use of the proceeds of the issuance, it would probably need to be empowered with capital and staff.

Are there technical or practical obstacles?

From a technical/practical point of view, eurobonds would not be so different from national bonds. The clearing and settlement structure in Europe is already in place and with the TARGET2-Securities (T2S) platform, European clearinghouses could connect directly to T2S. A bond issued by the ESM could therefore be settled directly through T2S. Access to these bonds will be ensured using the service of market makers, which is not difficult to achieve using transparent trading platforms.[11]

Eurobonds as part of ECB's QE programme

Eurobonds could be an important contribution to the implementation of monetary policy and be part of the ECB's Asset Purchase Programme (APP) and its portfolio and diversification strategy.[12] Even though the ECB has clearly stated that is not privileging sustainable bonds (e.g. green or social bonds), these are included as an eligible type of assets under the APP. In addition, eurobonds will eliminate concerns about not having too many bonds of a particular country, or the scarcity of safe assets more remunerative than German Bunds, or the depression of negative yields.

Eurobonds require coordination of fiscal policies

However, eurobonds would require a major coordination of fiscal policies. This is something that Europe needs to advance on, and the Commission's role would be vital here, but this coordination will take time. Judging by the time needed during the sovereign debt crisis in some European countries and by the highly unusual situation at that time, it could be anything between two to three years. Now, because Europe is facing a common problem that affects everyone, there need to be a more robust union in terms of public finances.

Is there a short-term solution?

Although eurobonds have been discussed more and more and pressure for a solidary response is mounting, it is still unlikely that any decision will be taken in the near future. Rather, there are likely to be some adjustments to a potential ESM programme (e.g. in terms of conditionality). However, an ESM programme could be used to trigger Outright Monetary Transactions (OMT) by the ECB, meaning more unlimited purchases of particular bonds from a particular member country (and from other countries as proportion to the capital key). That is a possibility.[13]

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[10] For an overview of recent balance-of-payments assistance programmes, see Alcidi, C., D. Gros, J. Núñez Ferrer and D. Rinaldi (2017), "The Instruments Providing Macro-Financial Support to EU Member States", CEPS Research Report, No. 2017/06, March, CEPS.

[11] Probably the most important choice for the inter-dealer platform is one that ensures continuity and solidity in terms of IT infrastructure and business continuity.

[12] But also part of the new Pandemic Emergency Purchase Programme (PEPP).

[13] Nevertheless, one of the conditions to use OMT is that there is an abnormal deviation between the yields paid by a country and what would be the fair value of its bonds (a deviation not justified by the fundamentals). But this is not the case with the corona crisis.

There is need for a permanent solution

Even though the current crisis is very specific, Europe should look to the future. Most likely, in a few months' time, there will be a need for a further fiscal stimulus. This is because when the current health emergency ends, the recovery will tend to be sluggish, not buoyant. Thus, there will be more risk aversion on the part of economic agents, similar to what happened after the 2008-09 crisis when saving rates went up.[14] Moreover, the destruction of productive capacity that we already experience will result in bankruptcies and increased unemployment, which will hamper any buoyant recovery. Furthermore, the interruption of the global supply chains will impact trade and growth due to strategic changes in many firms in their effort to localise production and shrink the supply chain. It might therefore be time for a permanent scheme of mutualised debt (i.e. a European safe asset),[15] but also for a programme of strategic investment (i.e. a true Investment Plan) – this time with significant public money involved to crowd-in private investment.

[14] So there will be no buoyant expenditure immediately after the crisis.

[15] See Lannoo, K. and A. Thomadakis (2019), "Rebranding Capital Markets Union: A Market Finance Action Plan", CEPS-ECMI Task Force Report, CEPS.

European Capital Markets Institute

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