

Delpla, Jaques; von Weizsäcker, Jakob

Research Report

Eurobonds: The blue bond concept and its implications

Bruegel Policy Contribution, No. 2011/02

Provided in Cooperation with:

Bruegel, Brussels

Suggested Citation: Delpla, Jaques; von Weizsäcker, Jakob (2011) : Eurobonds: The blue bond concept and its implications, Bruegel Policy Contribution, No. 2011/02, Bruegel, Brussels

This Version is available at:

<https://hdl.handle.net/10419/45535>

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EUROBONDS: THE BLUE BOND CONCEPT AND ITS IMPLICATIONS

JACQUES DELPLA AND JAKOB VON WEIZSÄCKER

Highlights

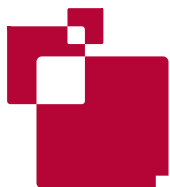
- The Blue Bond proposal, published in May 2010 (Bruegel *Policy Brief* 2010/03) suggests that sovereign debt in euro-area countries be split into two parts. The first part, the senior 'Blue' tranche of up to 60 percent of GDP, would be pooled among participating countries and jointly and severally guaranteed. The second part, the junior 'Red' tranche, would keep debt in excess of 60 percent of GDP as a purely national responsibility. This paper revisits the proposal, discusses its implications and addresses some of the comments and criticisms received in response to the proposal.

This paper was prepared for the European Parliament's Economic and Monetary Affairs Committee, session of 21 March 2011 on the interaction between bank and sovereign debt resolution. Copyright remains with the European Parliament at all times.

Jacques Delpla is an economist at the French *Conseil d'Analyse Économique*. Jakob von Weizsäcker is a Non-resident Fellow at Bruegel and an economist at the *Thüringer Ministerium für Wirtschaft, Arbeit und Technologie*.

Telephone
+32 2 227 4210
info@bruegel.org

www.bruegel.org



EUROBONDS: THE BLUE BOND CONCEPT AND ITS IMPLICATIONS

JACQUES DELPLA AND JAKOB VON WEIZSÄCKER, MARCH

IN MAY 2010, WE PUT FORWARD THE IDEA that euro-area countries should divide their sovereign debt into two parts. The first part, up to 60 percent of GDP, should be pooled as 'Blue' bonds with senior status, to be jointly and severally guaranteed by participating countries. All debt beyond that should be issued as purely national 'Red' bonds with junior status¹. While not a panacea for the current euro crisis, our proposal has two appealing features:

- First, the Blue Bonds would constitute an extremely liquid and safe asset on par with the US Treasury bond. This should help the rise of the euro as a major reserve currency, enabling the entire euro area to borrow part of the sovereign debt at interest rates comparable to, or hopefully even below, the benchmark German bond.
- Second, the Red Bonds would help to enforce fiscal discipline. They would make borrowing more expensive at the margin and strengthen market signals in the absence of a credible fiscal stance, thereby complementing the Stability and Growth Pact rules. Furthermore, according to our proposal, Red Bonds should be largely kept out of the banking system and could plausibly form the basis for the planned orderly default mechanism in the euro area.

On the basis of these two main features, we believe an attractive policy package could be constructed for fiscally stronger and weaker countries alike. Thereby, the Blue and Red Bond mechanism could become a permanent feature of sovereign debts in the euro area. Blue debt would be a super safe 'eurobond' that should never default. Red debt would be the part of the sovereign debt that would bear the lion's share of sovereign risk and which would be subjected to investor participation in case of crises.

In the next section we outline the main feature of the Blue Bond proposal and the key properties of this mechanism. The third section concludes by looking at 'frequently asked questions' we have received to date, thereby highlighting some of the policy issues at stake.

BLUE AND RED BONDS: BASIC CONSTRUCTION AND KEY FEATURES

As indicated above, the basic idea is to create two different sovereign assets for two different objectives. First, the Blue Bond would make the lion's share of sovereign borrowing in the euro area more affordable (up to the Maastricht debt limit of 60 percent of GDP) by creating an asset that satisfies the demand for super safe and ultra liquid investment opportunities, including from Asian central banks and other large investors looking for super safe assets. Second, the Red Bond would make borrowing more expensive at the margin, especially for countries pursuing unsustainable fiscal policies or lacking fiscal credibility, thereby reinforcing the rules-based Stability and Growth Pact through market signals.

Blue debt

Super safe: The Blue debt is the senior tranche (repaid before any other public debt – excepting only the IMF which enjoys super seniority) of the sovereign debt of the euro area participating countries. It is the part of any euro area sovereign debt that will be repaid under virtually all circumstances since it is issued only up to 60 percent of GDP, which is the Maastricht limit. As the debt-carrying capacity of any developed EU member state, even under extreme stress, stands well above that level and on top of this the Blue debt is jointly and severally guaranteed, it will enjoy super-safe AAA

1. Jacques Delpla and Jakob von Weizsäcker (2010) 'The Blue Bond Proposal', Bruegel Policy Brief 2010/03.

'The joint and several guarantee will ensure that Blue debt would be considered even safer than the current benchmark bond, namely the German Bund. Of course, for participating countries to merit such mutual guarantees, they must all commit to strict conditions.'

status, which we would like to call AAAA.

Joint and several guarantee: Blue debt is covered by joint and several guarantee, ie each country, each year, guarantees all the Blue debt of all other participating countries to be issued the following year. This guarantee may seem extreme, but it is restricted to the safest sovereign debt component of each country, the one deemed to never default². The joint and several guarantee will ensure that Blue debt would be considered even safer than the current benchmark bond, namely the German Bund. Of course, for participating countries to merit such mutual guarantees, they must all commit to strict conditions, which will be explained below.

60 percent GDP limit: The most important safeguard to guarantee the quality of the Blue Bond is the upper limit of 60 percent of GDP to be borrowed in Blue debt by any participating country. What is more, the allocation of Blue Bonds as determined by the Blue Bond governance mechanism may be decreased to well below the 60 percent limit in case of reckless fiscal policies, strengthening even more the fiscal sustainability incentives.

Governance mechanism: The annual allocation of Blue Bonds would be proposed by an independent stability council staffed by members who would enjoy a similar degree of professional independence to the board members of the European Central Bank (ECB). This allocation would then be voted on by the national parliaments of participating countries, having the ultimate budgetary authority required to issue the Blue Bond mutual guarantees. 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.

Entry: Full participation in the Blue Bond scheme should not be regarded as an entitlement but as something earned through enhanced fiscal credibility, by means of low debt levels or credible institutional guarantees (credible national fiscal rules in particular) that put public finances on a sustainable path.

Blue debt agency: From a bond market perspective, Blue Bonds need to be the operational equivalent of plain national sovereign debt. This necessitates the creation of a joint debt agency to which tax revenues would be transferred directly to avoid the holding discount customary for multilateral debt.

Red debt

Juniority: Red debt, consisting of the remainder of the sovereign debt, would be the junior tranche. In other words, it could and would be honoured only after the entire Blue debt has been fully serviced.

National responsibility: Red debt can never be guaranteed by another country; it cannot be bailed out by EU mechanisms (European Financial Stability Mechanism (EFSM), European Financial Stability Facility (EFSF), or the future European Stability Mechanism (ESM)). The 'no bail-out' clause would apply only and strictly to the Red debt. Red debt would be issued by national Treasuries. As a result, the size of the future ESM would remain low, as it would have to finance only primary deficits and not the roll-over of Red debt.

Not in banking system: In order to allow for an orderly default of Red Bonds, we propose that Red debt should largely be kept out of the banking system. This would be achieved through two

2. For instance, the current Greek debt crisis is due to the size of the debt (150 percent of GDP). Had Greece entered the crisis with a Blue debt of 60 percent of GDP, it would have been able to fully service it (3 percent of GDP at most), as its fiscal revenues were 35 percent of GDP; the debate about Greek debt would have focused only on Red debt. One of the main requirements of AAA status is that debt service be below 10 percent of total tax revenues; every year since 1992, Greek Blue debt would have easily met this requirement (including in 2009, 2010 and 2011). It is true that Spanish sovereign debt, despite being below 60 percent of GDP, is not AA now and bears spreads of more than 200 bps. The reason is not the sustainability of the current debt level but uncertainties about Spain's future sovereign liabilities (banks recapitalisations, skyrocketing unemployment and future pension liabilities, given Spain's low birth rates).

measures. First, Red debt should not be eligible for ECB refinancing operations. To avoid disruptions, this restriction could be implemented gradually when Red Bonds are introduced. Only Blue debt, the safe asset, should be eligible for ECB refinancing operations. Second, regulators need to assure that holdings of Red Bonds in particular should be backed up by painful capital requirements in the banking system.

Blue Bonds and the ‘exorbitant privilege’

One key advantage of the Blue Bond scheme is that it could help the rise of the euro as a reserve currency during a critical period where confidence in the US\$, the leading global reserve currency, is somewhat in decline.

The Blue Bond market would be extremely large (€5,000 billion to €6,000 billion, against €7,250 billion for the US Treasury bond market) which should help the Blue Bond enjoy the ‘exorbitant privilege’ previously exclusively enjoyed by the US. This exorbitant privilege consists of selling at low rates super-safe and ultra-liquid debt to world investors, especially the central banks and sovereign wealth funds of emerging markets. Warnock and Warnock (2009)³ estimate the ‘exorbitant privilege’ for the US Treasury at about 0.8 percent per year. Even if we take into account that the German Bund already enjoys a somewhat privileged position, it would appear possible that even Germany could reap greater benefits in the future, let alone other euro area countries. In our first paper, we provided a more conservative guesstimate of the possible gains: with Blue Bonds, euro area countries might save up to 0.30 percent each year on the stock of debt⁴, amounting to perhaps as much as a 10 percent reduction in the net present value of debt servicing costs. This is an order of magnitude we still find plausible.

Reinforcing the Stability and Growth Pact

Despite all its recent changes, the Stability and Growth Pact continues to suffer from significant problems:

- Its sanctions are not entirely credible.
- There are few positive incentives to encourage compliance with the SGP.
- In particular, incentives to run budget surpluses during good times remain weak.

Our proposal would help to strengthen the incentives of the Stability and Growth Pact. Blue and Red debts impose a double control on fiscal policies. First, there is an institutional control: the independent stability council allocates Blue Bonds according to the principles of the Stability and Growth Pact and notions of general fiscal sustainability, exemplified by national fiscal rules in particular. Second, borrowing costs for Red Bonds would be high, very high for countries in breach of the Stability and Growth Pact, thereby imposing market discipline on countries that lack fiscal credibility. By keeping Red Bonds largely out of the banking system, the prospect of an orderly default would become credible – unlike what we observe today.

FREQUENTLY ASKED QUESTIONS ABOUT THE BLUE BOND PROPOSAL

In this section, we attempt to address the most common criticisms we have received in response to our original proposal. Typically, we received critical reactions from fiscally stronger countries arguing that access to borrowing in Blue Bond was overly generous towards weaker countries. And also typically, the critical reactions from weaker countries argue that borrowing in Red Bonds would end up being far too expensive. Finally, we received some challenging questions regarding the credibility of the institutional setup. We have attempted to condense these criticisms into a number of representative questions, as follows:

Wouldn't borrowing costs increase for stronger countries when borrowing in Blue Bonds?

According to some reports in the German media, borrowing costs would increase by as much as EUR 17 billion per year with the introduction of ‘eurobonds’. This calculation was based on the observation that the average (weighted by debt

3. Francis Warnock and Veronica Warnock (2009) ‘International Capital Flows and U.S. Interest Rates’, *Journal of International Money and Finance*.

4. This estimate is the difference between swap spreads in Germany and in the US, in the ten years before 2007.

volumes) interest rate for euro area sovereign borrowing stands some 160 basis points above current German borrowing costs. It turns out that this calculation would only make sense if our proposal had been to pool, without conditions, the entire debt stock of the euro area. However, we have proposed to pool only sovereign debt stocks below the 60 percent of GDP threshold – and with many stringent conditions.

Since debt levels below that threshold are – under most circumstances – easily sustainable, default probability on the Blue Bonds would be very low. Furthermore, the Blue Bond would not only be a very safe but also an exceedingly liquid asset. Against this background, it would appear likely that borrowing costs in Blue Bonds will be attractive even when compared to the German Bund.

Wouldn't borrowing costs for Red Bonds of weaker countries in the euro area become prohibitive?

Rates on Red Bonds will of course be high, but that is, by itself, a deliberate and desirable feature of our proposal, because Red debt concentrates all the sovereign risk. From a static point of view, the differentiation between Blue and Red debt does not change the overall risk on a country's sovereign debt. The whole difference lies in the political dynamics implied by the introduction of the Red Bond.

In the past, stability oriented countries have attempted to impose fiscal discipline on fiscally weaker countries from the outside, with mixed success. The Red Bond would fundamentally alter this political set-up. In order to reduce borrowing costs for Red Bonds, weaker countries would start to develop a keen interest in institutional set-ups, such as credible fiscal rules, which enable them to signal to markets that they are indeed pursuing sustainable fiscal policies. Stronger countries and European institutions will then be happy to help

with this endeavour by making available some of their institutional credibility. For example, the pre-screening of budgets during the European Semester could evolve into a much more powerful mechanism in that context than it currently is.

In short: Red Bonds will force weaker euro area countries to change some of their old habits and acquire fiscal credibility. But once this is achieved, borrowing costs even in Red Bonds are set to become quite reasonable.

How can the 60 percent GDP limit for Blue Bonds be maintained politically?

Some critics fear that the 60 percent of GDP limit for borrowing in Blue Bonds will not hold out against massive incentives by many countries to see the limit increased to substantially higher levels. Those critics are right that such attempts are likely to be made and that they must be prevented from succeeding in order to ensure the credibility and maintain the good incentives of the entire scheme. In this respect, the scheme's governance structure is key. In our proposal, the independent stability council would assure that no Blue Bond allocations are ever put to vote in national parliament beyond the 60 percent limit according to its statutes. And, as a further safeguard, the opt-out mechanism for national parliaments would make it very hard to tamper with this set-up against the wishes of the stability oriented participant countries.

How would Blue and Red Bonds be introduced?

The introduction of Blue and Red Bonds could either occur gradually, with Blue and Red Bonds replacing legacy debt as it is rolled over, or in a big bang in exchange for the entirely legacy debt stock. The main advantage of the gradual approach is that it would allow the system to establish its credibility gradually with markets and

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European citizens, with some adjustments readily possible during the five to ten year introductory period. The main advantages of a big bang solution are twofold. First, a deeply liquid pool of Blue debt would be created overnight, rather than having to wait for many years for the full benefits of the system. Second, the big bang exchange could potentially be used for a comprehensive debt restructuring if the market view on debt sustainability in some of the crisis countries was to turn out to be accurate. However, the current IMF analysis of debt sustainability in Greece in particular comes to a different assessment right now.

Would the prospect of an orderly default on Red debt be any more credible than the now defunct no bailout clause for existing national debt?

Arguably, the single most important reason why the no bailout clause was *de facto* overruled in May 2010, when the Greek rescue package was adopted, was the fear of another serious banking crisis. In response, our proposal contains provisions that would make the holding of Red debt by banks comparatively unattractive in order to make an orderly default on Red debt credible.

Disincentivising banks from holding Red Bonds could be done in two ways. First, we propose that Red Bonds do not qualify for the ECB's repo facility. If need be, access to the repo facility could be phased out over several years in order to avoid market disruptions. Second, because Red debt will be risky and with ratings below the current sovereign debt, holding Red Bonds will be expensive for banks in terms of capital requirements. These provisions stand to make an orderly restructuring on red debt a realistic proposition.

How could the Blue and Red Bonds be used to complement the new ESM crisis architecture?

While the Red Bond creates the possibility for orderly losses as described in the previous sections, it does not provide the proper infrastructure to deal with crisis events. In our mechanism, the ESM would continue to exist in case of an IMF/EU programme. It would provide fresh money but only for primary deficits, as Red debt would be on hold [coupons suppressed and maturities automatically lengthened]. As a result, ESM size would not be large within our mechanism – the current EFSF size would be enough.