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Eurobills, not Eurobonds

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Fiscal union is now officially on the European agenda, but the issue of Eurobonds remains controversial. This column argues that the Eurozone needs Eurobills, ie debt of maturities less than a year. Issuing Eurobills – up to 10% of Eurozone GDP – would help with crisis management as well as financial regulation, and monetary policy, while minimising the risks of moral hazard.

Recent events have highlighted the need for stronger coordination of liquidity provision and financial regulation in the Eurozone. Some go further and argue that the crisis demonstrates the need for deeper integration including perhaps fiscal integration and Eurobonds.

Fiscal integration remains controversial because the risks involved are difficult to assess by taxpayers and politicians. Stronger countries are understandably reluctant to accept open-ended commitments that could threaten their own financial stability. Without proper oversight, jointly issued Eurobonds would expose member countries to potentially large moral hazard.

Proponents of Eurobonds, on the other hand, emphasise that common bonds could alleviate the current sovereign debt crisis and reinforce financial stability in the Eurozone. The two sides remain far from agreeing on a course of action.

Yet a cold look at the problem through the lens of economic theory suggests a compromise solution. The introduction of Eurobills – common debt with maturity of less than a year – could provide a large part of the benefits while allowing for significant checks on the risks, both in terms of magnitudes, and in terms of effective control.[2]

How our proposal would work

- First, Eurozone countries set up a joint debt management office (DMO) to issue the Eurobills.

The DMO is the only issuer of short-term bills for all Eurozone countries. The DMO manages issuances and redemptions, and monitors the allotments of each country.

Before the beginning of each quarter, the Treasuries of the EZ countries submit their schedules for issuances of all debts whose liability is less than a year. At

the beginning of the quarter, the DMO issues Eurobills to cover the needs of all countries over the course of the quarter.

On the dates where individual Treasuries would normally conduct their own auctions, the debts are simply bought directly by the DMO.

- The Eurobills auction: the DMO conducts auctions to satisfy the needs of all EZ countries, subject to the constraint that no country can have more than 10% of its GDP in Eurobills outstanding at any point in time.

A practical issue is what to do with the unbid amount, if there is any. We propose to follow the German model. In Germany, the Bundesbank steps in to retain any unbid amount. In our proposal, the ECB would do the same for Eurobills.

- Eurobills are the joint-and-several liabilities of the Eurozone.

Given our proposal to follow the German model, there is no technical issue of failed auction, but the ECB is obviously not meant to be the ultimate buyer of Eurobills. If, for whatever reason, the ECB ends up retaining some Eurobills, the member states must repurchase them within one quarter. Should a member state be unable to fulfil its obligations, other states are required to step in and increase their own repurchase.[2]

- Participation in Eurobills emissions is conditional on satisfying criteria of economic governance and budgetary discipline.

Countries are not allowed to issue any more short-term debt on their own. They continue issuing their own debt for maturities of two years and more.

- European banking regulators announce that Eurobills are the main (perhaps the only) level 1 sovereign asset for liquidity ratios (Basel III).
- Eurobills can be phased in as soon as the DMO is created.

Countries do not need to change their planned issuances. All that happens is that these issuances are now pre-funded by Eurobills auctions as described above.

The rationale

The key idea is to prevent self-fulfilling liquidity runs and the negative feedback between sovereign and banking crises, while minimising the risk of moral hazard.

- The first point to emphasise is that our proposal is not a substitute for improved economic governance and fiscal discipline.

It is complementary to these measures. Indeed, by making access to Eurobills conditional on sound long-term fiscal policy, our proposal strengthens the existing framework.

- Second, Eurobills would replace existing short-term debts, and not expand the overall amount of short-term debt.

The specific number of 10% of GDP is based on the US market. US Treasury Bills, whose maturity is less than a year, represent about 10% of US GDP.[3]

It is important that countries give up their right to issue short-term debt. This is, in our view, the only credible way to make Eurobills effectively senior to all other liabilities that countries issue. Eurobills would cover the maturity range from one month to one year, and individual countries would only be able to issue maturities beyond two years.

Our proposal would incentivise countries to issue more long-term debt. In addition, to the extent that Eurobills improve financial stability, they will make it cheaper for countries to borrow long.[4]

- A strict limit on the size of the issuance together with credible seniority is critical for convincing strong countries to accept the joint-and-several liability.

In turn, the joint guarantee is required to make Eurobills as safe as the short-term debt of the best borrowers in the Eurozone, and even more liquid. If a country fails to pay its Eurobills, other countries are liable.[5]

It is also important that all countries participate in the programme, for two reasons. Strong countries must participate otherwise a stigma could arise and the market could unravel.[6] We also do not want short-term debt from strong countries to compete with Eurobills. This would reduce liquidity and create room for adverse selection.[7]

Financial stability regulations and the demand for safe, liquid assets

Eurobills are justified on the grounds of financial stability regulation. The Basel III framework imposes new liquidity ratios on banks, creating a large new demand for liquid assets. A potentially dangerous aspect of Basel III is that banks can use sovereign debt to satisfy their liquidity ratios irrespective of the credit quality of the sovereign. This can undo the liquidity benefits and leave room for negative financial feedback if the bank or the sovereign runs into trouble.[8]

Reasonable people can disagree about the need for fiscal integration, but

everyone should agree that financial stability in a monetary union requires integrated banking regulation and a set of common financial instruments.

Eurobills are a market waiting to happen. To illustrate, let us imagine issuances of 10% of Eurozone GDP. This would mean a supply of about €800 billion. On the demand side, estimates of the extra demand for liquid assets by EU banks to satisfy the Basel III ratios exceed €500 billion (JP Morgan 2011). Globally, the demand for risk free assets has never been stronger. The argument that a crisis is a bad time to introduce a new security therefore does not apply to Eurobills.

Illiquidity versus insolvency

There can be no doubt that there are large benefits from having a single highly liquid asset used for reserve and liquidity management.

- In normal times, short-term bills are money-like instruments that would help the ECB implement its policy;
- In crisis mode, the objective of the new liquidity instrument must be to protect countries with fundamentally sustainable fiscal policies from the threat of contagion.

Eurobills are meant to prevent liquidity crises. The point is that liquidity freezes can quickly become self-fulfilling. When countries are forced to refinance themselves at unsustainably high rates for prolonged periods, liquidity risk can morph into solvency risk. When using this new instrument in times of crisis, a clear separation between liquidity and solvency issues is critical.

Importantly, because Eurobills are limited in size and in maturity, they do not create open-ended commitments, and they cannot be used to bail out insolvent countries, and therefore would not violate the spirit of the Treaty provision against bailing out member governments

To put the numbers into perspective, if Spain, Belgium or Italy were to use their entire quota of Eurobills (10% of GDP), this would cover about half of their refinancing needs for 2012. Thus these countries would still need to convince market investors of their solvency. But at the same time, Eurobills would give them time to implement credible fiscal reforms.

Debt seniority and moral hazard

Our proposal takes the issue of moral hazard very seriously. In our view the critical issue is to make sure that Eurobills are senior to other debts, and that all participants (investors and governments) understand this point. Our proposal would then be complementary to budgetary discipline and fiscal surveillance.[9]

It is important to understand that effective market discipline requires that jointly issued debt be credibly senior to any other debt. Enforcing this is difficult and risky.

- A time-honoured solution to seniority enforcement difficulties is to shorten the maturity of the contracts.
- Short maturity makes the Eurobills effectively and credibly senior.

Effective seniority is why we prefer Eurobills to Eurobonds.[10] This is a standard argument in corporate finance theory. It is difficult to make long-term claims effectively senior because borrowers can engage in side contracts, hidden pledge of assets, risk shifting and maturity shortening. These issues only become more relevant when we move from corporate to sovereign borrowing.[11]

From a governance perspective, the fact that Eurobills have to be rolled over at least once a year gives more bargaining power to the agency in charge of fiscal surveillance. This idea is also standard in corporate finance and is similar to stage financing for complex projects whose contingencies are difficult to forecast. The creditors want to be able to assess the progress of the project at regular intervals, and would not want to offer non-contingent long-term commitments.

Eurobills are simple and transparent. This makes the costs of implicit guarantees easier to assess. Here we think that banking regulations are also critical. By transferring cross-country exposures from bank balance sheets to the public domain, Eurobills facilitate monitoring and therefore mitigate moral hazard. The total joint exposure in our proposal is also far smaller than what is implied by implicit bank bailout guarantees that are already *de facto* operative. The simplicity of Eurobills also distinguishes our approach from proposals based on tranching and more complex financial structure.[12]

Conclusion

European integration is always easier when it can be done in small steps, especially in the midst of a crisis.

If joint-and-several liability debt is to be part of the solution, then our argument is that Eurobills are the instrument that minimise moral hazard and therefore should be considered first.

A market for Eurobills can start small, improve financial stability and banking regulation, and provide much needed liquidity to solvent countries. In all these respects, Eurobills fit the bill.

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[1] Following the practice of using the name 'bills' (rather than bonds) for US debt with maturities under one year.

[2] In all these examples, burden-sharing is simply proportional to GDP.

[3] In France BTF are also about 10% of GDP, and in Germany Bubils are about 5% of GDP.

[4] Short-term debt is already *de facto* senior. So replacing it by Eurobills would not increase the risk for long-term debt. In fact, for countries currently paying a high short rate, this would lower long-term risk.

[5] There is no point in issuing jointly if the instrument is not obviously safe to all

investors. We would argue that it is distinctively better to have a small amount of totally and unambiguously safe debt rather than a larger amount of debt of hard-to-assess credit quality (we come back to this point later when we discuss the demand for Eurobills and their use in financial regulation).

[6] See Philippon and Skreta (2011) and Tirole (2011) for an analysis of this problem.

[7] This is an important issue with Eurobonds that has not been addressed so far (see European Commission, 2011). Our proposal offers a credible solution by granting monopoly issuance to the Eurobills agency over a well-defined and restricted maturity range.

[8] And even if all countries are ex-ante similar and solvent, home bias in liquidity holding creates the possibility of market freezes with *ex post* heterogeneous country-specific securities. See Albagli *et al* (2011) for a discussion of asymmetric information and asset prices. See Guerrieri *et al* (2010), Guerrieri and Shimer (2011), and Chang (2011) for discussions of adverse selection, illiquidity and market freezes with heterogeneous securities.

[9] In fact, it would help improve governance if access to short-term funding or credit lines is conditional on meeting fiscal targets. Eurobills are also consistent with the introduction of restructuring mechanism for long-term debt (Weder di Mauro and Zettelmeyer, 2010).

[10] See the well-known blue debt/red debt proposal of Delpla and von Weizsacker (2010). There are two main differences. One is the size of the program. Eurobills would only replace short-term debt and would be less than 10% of GDP, instead of 60% for the Blue debt. The other is that we propose to segment the market by maturity, for two reasons. One is the credibility of seniority. This is well understood in the corporate finance literature. Another is that we do not want Eurobills to compete directly with other instruments. As explained above, it is important for all countries to participate to avoid adverse selection and market collapses. Of course, one can also view our proposal as a credible way to implement a two-tiered debt system. Eurobills would be small and permanent, so they could be complement to the proposal by the German Council of Economic Experts (2011)

[11] Sovereign states have large amounts of implicit guarantees (pensions, health costs, social safety nets) and all of these can be used for risk shifting. To be credibly protected, a long term bond would have to stipulate an immense set of contingencies and covenants. From a political economy perspective we doubt that this can really be achieved.

[12] See Brunnermeier *et al* for innovative ideas along these lines.

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