

## Europe's Futile Search for Cheaper Money

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11 February 2011

Various forms of common 'European bonds', or more precisely eurobonds, have been proposed recently as a way out of the current euro crisis, with proponents stressing the promise of lower borrowing costs. But this seems mostly to be wishful thinking.

To see why, one needs only to reflect on the longer-term benefits that one might expect from such bonds. Would European bonds carry lower interest rates than the average rates for national bonds?

Proponents of European bonds argue that they would create a much larger and more liquid market than those for national bonds. But this advantage is likely to be limited, a potential savings of a few tenths of a basis point, given that the interest rates on similar, high-quality sovereign bonds – such as those issued by Germany and Austria – differ by only this amount.

Another purported advantage of European bonds could be risk pooling: if the risks that individual eurozone members experience payment difficulties were not too dissimilar – and not too closely correlated – joint issuance of bonds should, in principle, reduce credit risk for European bonds relative to the average risk of national bonds.

But that is not an argument that can be used at the present time, when eurozone risks are so lopsided (zero for the core and considerable for the periphery) and, among peripheral countries, so highly correlated (they are vulnerable to the same shocks, e.g. higher interest rates or low growth).

Thus, the eurozone-wide gains from European bonds are likely to be negligible. The key insight of the dismal science bears repeating: there is no free lunch. What debtor countries gain in terms of lower financing costs would be offset by the losses for creditor countries both in terms of higher borrowing costs and lower interest income.

But countries such as Greece, Ireland, Portugal and Spain face a real problem: now that their consumption and construction booms have ended, a long period of slow growth looks unavoidable. At the same time, they have to pay much higher interest rates, driving up their debt while their capacity to service that debt stagnates. Lower interest rates are thus vital for these countries.

But it is unlikely that European bonds would achieve even this limited aim. There have been many proposals, but all share two features. First, they would allow eurozone countries to issue bonds that are guaranteed "jointly and severally" by all members up to a certain level – for example, 40% of GDP, as in the latest proposal by Luxembourg's Prime Minister Jean-Claude Juncker and Italian

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Finance Minister Giulio Tremonti. Second, the European bonds would be senior to private claims. This second component is crucial, because it would make all other government debt junior.

In practice, this would mean that if Greece, say, were to have to restructure its debt once the bonds had been issued up to the limit, it would presumably service these bonds (which essentially represent official multilateral debt) in full, with private lenders bearing all the losses. The value of private claims would thus fall.

Issuing European bonds would not lower a country's overall debt, but only change its composition. We know that companies cannot change their total market value by changing the composition of liabilities (making some claims senior to others). The same applies to countries: making some claims senior to others would not lead to lower average borrowing costs, owing to the higher cost of private financing after it is reduced to junior debt.

The partial substitution of national debt with European bonds might reduce the marginal debt-service cost for distressed countries while they are being issued. Ultimately, however, their average cost would not be lower, because, again, if official creditors are senior to private lenders, large-scale official financing – which is used mainly to repay maturing debt – would impede governments' access to private credit markets.

Moreover, as more European bonds are issued, this problem becomes more acute, because the existing overhang of private debt becomes increasingly risky. As borrowing costs tend to rise proportionally more than the increase in risk, a country with a large volume of European bonds outstanding might actually face higher borrowing costs. Experience also shows that bad risks are often shut out of the market, which implies that a country with a high debt burden and many European bonds outstanding might not be able to issue any private debt at all.

Of course, if member countries were willing to pool all their borrowing, they might gain, on average, a small reduction in debt-service costs. But this would require Europeanization of overall economic policy, including, for example, tax rates and pension rules. Given that eurozone members rejected even the idea of automatic sanctions for countries with excessive deficits, they are not likely to countenance such a wide ranging loss of sovereignty.

Does this imply that European bonds are a bad idea in general? No. If all member countries had little public debt, issuing European bonds up to 40% or 60% of GDP would cover all their funding needs, and they could reap a modest liquidity premium. Markets would not allow them to issue much additional debt, and there would be no default risk. A key condition for contemplating European bonds is thus that public debt first be reduced to a sustainable level. But this is not on the official agenda, at least for the time being.