THE LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE

Research impact: making a difference

Designing an innovative Eurozone bond to avert future Greek-style crises

Professors Luis Garicano and Dimitri Vayanos were key players in the development of a new Eurozone-wide investment structure

What was the problem?

The ongoing European financial crisis, most starkly represented by the challenges facing the Greek economy, has exposed significant flaws in the design of the Eurozone financial system.

Because current Eurozone policy promotes capital flow across borders, in turbulent times investors run from some countries, such as Greece or Spain, to park their investment in safe havens, such as Germany. Seeing their bond price collapsing, the countries considered at risk then have to tighten their budgets, which often leads to a contraction of their economies. This in turn serves to validate the market's pessimistic expectations, thereby sparking more investor flight and the eventual need for weaker Eurozone countries to be supported by stronger ones.

To address these challenges, analysts have long suggested the creation of a Eurozone-wide investment bond, which would be issued jointly by all Eurozone member countries and therefore be seen as more desirable than bonds issued by individual member states.

In 2014, an article in *Reuters* described the lack of a credible bond as one of the ‘birth defects’ of the Eurozone. Yet the many proposals to this effect were fraught with significant political and fiscal challenges, rendering them unacceptable to member countries.

What did we do?

Between 2010 and 2012, an international group of eight economists collaborated to explore the key obstacles to a Eurozone bond. The group included two LSE professors: Luis Garicano, Professor of Economics and Strategy, and Dimitri Vayanos, Professor of Finance. Other members were Markus Brunnermeier, Princeton University; Philip R. Lane, Trinity College, Dublin; Marco Pagano, University of Napoli Federico II; Ricardo Reis and Tano Santos, Columbia University; and Stijn Van Nieuwerburgh, New York University.

A key challenge identified by the team was that existing proposals involved a handing over of substantial sovereign fiscal autonomy to Brussels, which was considered politically infeasible by many Eurozone members. The group also concluded that existing bond propositions didn’t sufficiently solve the problem of stronger economies bearing disproportionate responsibility for weaker ones, which is at the root of the current Eurozone crisis.

The group's research produced a proposal to create a European Debt Agency that would purchase sovereign debt equivalent to as much as 60% of the total Eurozone GDP. To finance this purchase, the agency would issue two bonds. The first bond, called a European Senior Bond, or ESBie, would encompass the debt of the stronger Eurozone economies and therefore be perceived as lower risk, although with consequently lower return on investment. A second security, the European Junior Bond (EJB), would include mostly higher-risk sovereign debt, yet with potentially higher return and thus appealing to high-risk/high-yield investors such as hedge funds.

> "The principal short-term objective of all common securities for the Eurozone is to bring stability. The ESBies proposal is the most focused on that objective."
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> **From "Making sense of Eurobond proposals," Vox EU, Aug 2012, coauthored by Stijn Claessens, Senior Adviser in the Division of International Finance, Federal Reserve Board**

The structure proposed by Garicano and his colleagues would not imply any change in European treaties. Because the bonds were effectively a repackaging of existing debt, they would not require additional funding by member states nor any need to transfer any sovereign fiscal policymaking to Brussels. Critically, the proposed bonds would not involve joint liability; if one member state defaulted, only the riskier bond would take the loss.

What happened?

The proposal by Garicano and his colleagues quickly became a leading option in the discussion of Eurozone-wide bonds. Members of the group were invited to discuss the proposal at the International Monetary Fund (IMF) and the Banca de Italia. Garicano and Vayanos discussed the proposal at an event convened by the Banque de France to focus on the Eurozone sovereign debt crisis, and the following year presented the group's work to the European Bank for Reconstruction and Development (EBRD).

In 2013, Garicano was invited before the UK House of Lords EU Sub-Committee on Economic and Financial Affairs to discuss the Eurozone crisis and was given the opportunity to outline the Eurozone bond proposal. Garicano also discussed the proposal informally with the Spanish Prime Minister, and Garicano, Vayanos and other team members presented the concept in closed sessions with policymakers across Europe, including ministers from Germany and the Netherlands.

A number of policy articles also resulted from the proposal, including an IMF working paper that favourably compared it to several other possible Eurozone bond structures. The Centre for Economic Policy Research (CEPR), an independent network of more than 800 economists conducting research on the European economy, featured several articles and analyses of the proposal on its influential blog VoxEU. The most recent was a November 2014 article authored by Garicano and Lucretia Reichlin of London Business School, focusing on the potential for the ESBies/EJBs as an alternative structural mechanism for proposed Eurozone quantitative easing measures.

In popular media, Garicano, Vayanos and colleagues published opinion pieces on their proposal in the Spanish newspaper *El Pais* (which featured it in on the front page), *The Wall Street Journal*, and the Italian newspaper *Corriere della Sera*. Feature articles and analyses of the proposal also appeared in *Diario de Noticias* (Portugal), the *New York Times*, the *Irish Times*, *Süddeutsche Zeitung* (Germany), and the Greek newspaper *Kathimerini*, among other publications.

Luis Garicano is a Professor in Managerial and Economics Strategy within the Department of Management. He has been the Director of Research in the Department and has worked as an economist for the Commission of the European Union and has been involved in efforts to promote structural reforms in the Spanish economy. In particular he has co-authored proposals to reform the labour markets, housing markets, and the pension and health systems. He recently wrote a best-selling book on these reforms "El Dilema de Espana", (Destino 2014).

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Dimitri Vayanos is Professor of Finance at the London School of Economics, where he also directs the Paul Woolley Centre for the Study of Capital Market Dysfunctionality. He received his undergraduate degree from Ecole Polytechnique in Paris and his PhD from MIT. Prior to joining the LSE, he was faculty member at Stanford and MIT. His research, published in leading economics and finance journals, such as the Journal of Finance, the Journal of Financial Economics, the Quarterly Journal of Economics, the Review of Economic Studies, and the Review of Financial Studies, focuses on financial markets, and especially on what drives market liquidity, why asset prices can differ from assets' fundamental values, why bubbles and crises can occur, and what are appropriate regulatory and policy responses. He is an Editor of the Review of Economic Studies, a Fellow of the British Academy, a Director of the American Finance Association, a Research Fellow at CEPR and a past Director of its Financial Economics program, a Research Associate at NBER, and a current or past Associate Editor of a number of journals including the Review of Financial Studies and the Journal of Financial Intermediation.

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