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Making Europe Safer

A cleverly designed bond instrument can ensure the euro zone's survival without a fiscal union.

The following is an open letter by the international Euro-nomics academic group (www.euro-nomics.com), composed of Markus Brunnermeier, Luis Garicano, Philip R. Lane, Marco Pagano, Ricardo Reis, Tano Santos, Stijn Van Nieuwerburgh and Dimitri Vayanos.

While the euro zone's crisis reflects deep structural problems, its suddenness and severity are due to flaws in the design of the monetary union, not its intrinsic properties. Many believe that Europe needs large fiscal transfers and euro bonds to end the crisis. But a cleverly designed bond, coupled with key reforms in bank regulation and monetary policy, could ensure the euro zone's survival without a fiscal union.

European bank regulators have treated all sovereign bonds as if they were riskless when computing Basel capital requirements, and the European Central Bank continues to accept all of them as collateral. This encourages banks to hold too much sovereign debt, and to tilt their portfolios toward riskier bonds that pay a higher yield. The result is poorly diversified banks and excessive exposure to the riskier sovereigns.

When the crisis came, this situation turned into a diabolic feedback loop. Doubts about the solvency of the sovereigns fed doubts about the solvency of the banks. Sovereigns, in turn, felt compelled to rescue their banks with public funds, justifying the initial fears about national default.

Breaking free from this trap requires banking regulation under which sovereign bonds possess risk-weights that reflect their true risk. European banks would then become better diversified and hold less sovereign risk, stopping the contagion to sovereigns.


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We propose that these objectives can be accomplished by creating "European Safe Bonds" (ESBies) that banks can hold and that the ECB would accept as collateral. Such bonds would help meet the worldwide hunger for safe assets, particularly in times of crisis, when investors seek a safe haven. ESBies would be liquid and would lower the borrowing costs for all euro-zone sovereigns.

How would these bonds be created? A new European debt agency would buy and passively hold the sovereign bonds of member nations with fixed weights set by a strict rule proportional to lagged GDP. The rule would be included in the ESBie contract, leaving no room for political interference without triggering lawsuits. The new debt agency would then use the bonds as collateral to issue two securities.

The first security, the European Safe Bonds, would have a senior claim on the payments from the bonds in the portfolio. For example, the first 70% of income would be paid to ESBie investors. This way, payment on the Safe Bonds would not be jeopardized even in a worst-case scenario, such as a default by Greece, Portugal and Ireland and a substantial haircut on Italian and Spanish debt. To make the securities even safer, the issuing agency could offer a capital guarantee, using some initial funds paid in by member states. This capital would be used to pay

the holders of ESBies in the event of catastrophe.

The second security would be the junior tranche backed by the portfolio of bonds. Unlike ESBies, this second security is a risky one because it absorbs the first losses on the portfolio. Hence it offers higher returns on average to compensate for the risk. Private investors like hedge funds could hold this riskier security for its higher returns and because it gives them embedded leverage that, unlike borrowing on margin, cannot be suddenly reversed in a crisis.

Europe's financial system would be safer if new banking regulation induced banks to move their portfolios toward European Safe Bonds, since this would cut the contagion link. Because the agency that issues ESBies would buy only a fraction of each country's total debt, national governments would still have to find private buyers and pay market interest rates that reflect their risk. This would provide the incentive to manage their public finances prudently.

European Safe Bonds are not euro bonds. They do not require one country's taxes to pay for another country's spending, nor do they require changes to the European treaties. ESBies are also not like mortgage-backed securities. They are designed to be safe, not to maximize the issuer's profits, and they are simple and transparent, so they cannot be manipulated to trick buyers.

ESBies alone will not solve all of Europe's current problems. Sound financial markets require constant vigilance. But ESBies would provide a way out from the regulatory gaps at the origin of the crisis, and they lay the foundation for a stronger euro zone in the long run.

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