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E-bonds would end the crisis

di Jean-Claude Juncker and Giulio Tremonti

In spite of recent decisions by European fiscal and monetary authorities, sovereign debt markets continue to experience considerable stress. Europe must formulate a strong and systemic response to the crisis, to send a clear message to global markets and European citizens of our political commitment to economic and monetary union, and the irreversibility of the euro.

This can be achieved by launching E-bonds, or European sovereign bonds, issued by a European Debt Agency (EDA) as successor to the current European Financial Stability Facility. Time is of the essence. The European Council could move as early as this month to create such an agency, with a mandate gradually to reach an amount of outstanding paper equivalent to 40 per cent of the gross domestic product of the European Union and of each member state

That would bring sufficient size for it to become the most important bond market in Europe, progressively reaching a liquidity comparable to that of US Treasuries. But to ensure this happens, two further steps must be taken. First, the EDA should finance up to 50 per cent of issuances by EU members, to create a deep and liquid market. In exceptional circumstances, for member states whose access to debt markets is impaired, up to 100 per cent could be financed in this way. Second,the EDA should offer a switch between E-bonds and existing national bonds.

The conversion rate would be at par but the switch would be made through a discount option, where the discount is likely to be higher the more a bond is undergoing market stress. Knowing in advance the evolution of such spreads, member states would have a strong incentive to reduce their deficits. E-bonds would halt the disruption of sovereign bond markets and stop negative spillovers across national markets.

In the absence of well-functioning secondary markets, investors are weary of being forced to hold their bonds to maturity, and therefore ask for increasing prices when underwriting primary issuances. So far the EU has addressed this problem in an ad hoc fashion, issuing bonds on behalf of member states only when theiraccess has been seriously disrupted. This week the European Central Bank took further steps to stabilise the secondary market. With a single European market, primary market disruptions are in effect precluded, reducing the necessity for emergency interventions in the secondary market.

A new market would also ensure that private bondholders bore the risk and responsibility for their investment decisions. In this way, the E-bond proposal usefully complements recent decisions aimed at providing clarity about a permanent mechanism to deal with debt restructuring. It would help to restore confidence, allowing markets to expose losses and ensuringmarket discipline. Allowing investors to switch national bonds to E-bonds, which might enjoy a higher status as collateral for the ECB, would help to achieve this. Bonds of member states with weaker public finances could be converted at a discount, implying that banks and other private bondholders immediately incurred the related losses, thus ensuring transparency about their solvency and capital adequacy.

An E-bond market would also assist member states in difficulty, without leading to moral hazard. Governments would be granted access to sufficient resources, at the EDA's interest rate, to consolidate public finances without being exposed to short-term speculative attacks. This would require them to honour obligations in full, while they would still want to avoid excessive interest rates on borrowing that is not covered via E-bonds. The benefits from cheaper, more secure funding should be considerable.

A liquid global market for European bonds would follow. This would not only insulate countries from speculation but would also help to keep existing capital and attract new flows into Europe. It should also foster the integration of European financial markets, favouring investment and thus contributing to growth.

Ultimately the EU would benefit too. Profits from conversions would accrue to the EDA, reducing effective E-bond interest rates. As a result EU taxpayers, and those member states currently under attack, would not have to foot the bill. All these benefits could be extended to member states that remain outside the eurozone.

We believe this proposal provides a strong, credible and timely response to the ongoing sovereign debt crisis. It would endow the EU with a robust and comprehensive framework that not only addressed the issue of crisis resolution but also contributed to the prevention of future crises by fostering fiscal discipline, supporting economic growth and deepening European integration.

The writers are prime minister and treasury minister of Luxembourg and Italy's minister of economy and finance.