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# A Eurozone Bond Solution With Its Own Problems

**‘European Safe Bonds’  
might help the ECB exit  
quantitative easing, but  
at a steep economic cost.**

By **Marcello Minenna**

**I**n the eurozone, sometimes everything old is new again. Witness how an idea for creating safe eurozone bonds devised in the heat of the sovereign crisis six years ago is reappearing as a solution to a very different problem. That’s right: ESBies are making a comeback.

In 2011, a team of economists proposed the idea of European Safe Bonds as a replacement for German Bunds and safe-haven investment in the eurozone. The concept is similar to an asset-backed security. An asset-management company would raise cash on the market by selling new ESBies, then use the cash to buy eurozone government bonds from banks.

Because the portfolio effect would reduce the riskiness of any individual sovereign-bond issue within the pool, this would create a new bond that could serve as high-quality collateral. Because banks in crisis economies would have been able to unburden themselves of bonds issued by their own struggling governments, this would reduce the risk of bank nationalization.

The idea never went anywhere during the crisis. It was overtaken by events, and before anyone could start creating ESBies, the European Central Bank dove into alternative policies to deal with the crisis.

But now some economists think it’s time to dust off the ESBie in response to a different challenge: how the ECB can exit from its asset purchases, or quantitative easing.

The ECB faces a problem as it starts to contemplate winding down its purchases of government bonds, or even reducing its balance sheet by selling the €1.7 trillion (\$1.9 trillion) holdings of sovereign bonds it will have amassed by December. The central bank has become such an important buyer in eurozone bond markets that an exit could trigger significant price declines on government bonds, including in crisis-prone economies.

ESBies are being floated as a solu-

tion. Shifting the ECB’s individual sovereign-bond holdings into an ESB asset manager would create a stable market for those bonds while removing them and their risk from the ECB balance sheet. The securitization of those bond holdings in turn would shift the risk back into the marketplace in a safer form less likely to trigger a yield spike.

Unfortunately there are some problems. ESBies aren’t designed to work as eurozone government bonds. The risks embedded in government bonds purchased by the asset-management company aren’t shared among the eurozone members. Each country retains its own default risk and the associated yield demanded by the markets, as well as the spread over any safer assets, be it an ESB or a Bund.

Put another way, because the ESB asset manager would securitize only some of the bonds issued by a government—and because there still would be no fiscal-transfer mechanism by which “safe” governments would guarantee repayment of riskier debts—ESBies wouldn’t prevent the yields of individual sovereign bonds from fluctuating.

The project to create a European safe bond fails the reality test in other ways. To allow for the issuance of low-risk securities, the proposal relies on two ingredients: a predominant investment in Bunds on the asset side and a capital structure with at least two tranches of ESB issues on the liabilities side.

German prominence within the portfolio of bonds held by the vehicle wouldn’t be a nice thing for indebted countries, especially Italy. Should ESBies become widely available in the eurozone, banks wouldn’t need riskier governments’ debt as collateral. There would be a greatly reduced demand for the public debt of riskier countries that hadn’t been absorbed by the vehicle.

This would force those governments to pay significantly higher yields in auction to refinance debt.

Their unpalatable alternatives would be rapid and deep tax increases and spending reductions to balance their budgets or—worse—giving up fiscal sovereignty to a newly instituted European authority.

As for tranching, it is a well-known tool of risk repackaging: The losses incurred in the underlying portfolio primarily hit the junior slice of securitized bonds and reach the senior tranche only when the junior has been completely exhausted. According to the authors of current ESB proposals, eurozone banks would purchase only senior securities while junior tranches would be fully underwritten by speculative investors.

If that really happens, ESBies could improve the creditworthiness of peripheral banks. But things might go differently.

The main problem is that the level of returns earned by the asset holdings of vulnerable-country banks must match their higher funding costs. These banks could end up having to invest in the riskier tranche of ESBies to achieve suitable returns. The final outcome would be risk segregation with senior ESBies replacing Bunds in core countries’ banks and junior securities replacing riskier sovereign bonds in banks of the periphery. It starts to resemble the status quo.

Seven years after the start of the eurozone sovereign crisis, policy makers continue to look for ways either to make the old system of fragmented sovereign risk work better or to make fiscal union politically viable. ESBies may go in and out of style, but they’re never a solution to that problem.

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La soluzione dei bond dell'eurozona presenta dei problemi