The pitfalls and possibilities of coronabonds

The Covid-19 crisis has renewed calls for the creation of common bonds for member states of the Eurozone. However, as **Zarko Kalamov** *and* **Klaas Staal** *explain, common bonds would have potentially far-reaching implications. They outline some of the existing proposals, identify their weaknesses and propose some possible solutions.*

Currently, we are in a state of crisis, with sweeping economic consequences. To mitigate these consequences, governments are proposing costly fiscal stimulus measures. Financing these measures is expected to involve additional public borrowing. As the financial positions of European countries vary widely, this borrowing comes at low cost to some, but likely entails prohibitively high costs for other governments.

One of the proposed policy responses is therefore the mutualisation of public debt, in the form of so-called Eurobonds or coronabonds. Because these bonds would be backed by all member states, they should have a high credit rating and low interest costs. Depending on the implementation of common bonds, however, this could imply moral-hazard and redistributive consequences that have far-reaching implications for public support for cooperation in the European Union.

One option for introducing common bonds would be the full substitution of common bonds for national bonds with several and joint guarantees. This means that every country would be fully responsible for the debt of others. The implication is that interest rates for all countries would be equal; whenever a country does not service its debt then all the others would be obliged by the joint guarantees to pay. The amount of a country's borrowing would no longer affect the rate of interest it has to pay on its debt. This would thus remove the incentive to limit public debt, and hence induce a large moral hazard problem.

Video conference between EU Economic and Finance Ministers on 16 April 2020, Credit: European Union

The same effect emerges if the European Central Bank (ECB) purchases the bonds. It has been argued that "this step would make them [Eurobonds] risk-free". These bonds are not risk-free, however, as countries may still default. It is also not true that, however implemented, Eurobonds do not have distributional consequences. This is obviously clear when countries, in the case of a default, have to repay the debts of others. It is also the case when these bonds "remain on the central bank's balance sheet until the end of time". The ECB is owned by the national central banks, and these are ultimately owned by the citizens of the member states of the Eurozone. Adding bonds below market value (and that is what buying bonds with a low credit rating until the market rate falls to the risk-free interest rate implies) thus ultimately comes at a loss for citizens. The benefits of putting bonds on the ECB's balance sheet are for those paying at a level higher than the risk-free rate – again, this is only a subset of the member states of the Eurozone.

Another option is the so-called blue-red approach. In this approach, there is partial substitution of common bonds for national bonds with joint guarantees. Up to a certain limit (for example, 60% of GDP), countries issue common or "blue" bonds. Once this threshold is reached, governments issue national or "red" bonds. This implies fewer moral hazard problems, as interest rates increase if countries overborrow. The blue-red proposal also carries fewer redistributive consequences than full substitution by common bonds. It is questionable, however, whether the ceiling is politically stable. Due to the joint guarantees, there would be a large wedge between the interest on "blue" and the "red" bonds creating large political pressures on increasing the ceiling.

A third approach introduces partial substitution of common bonds for national bonds with several but not joint guarantees. Common bonds would be senior to the national bonds, and countries would have to guarantee only a part of the total amount of common bonds issued. This part is proportional to the issuance of common bonds by a country. This lowers the moral hazard, since overborrowing by a country is not covered by the guarantees and thus is done at a higher interest rate, reducing overborrowing.

This higher rate is, however, only charged for the additional borrowing and this type of common bond thus lowers the total cost of borrowing. The total costs of servicing the debt decrease, and a country has less to gain from a bailout. This reduces the number of bailouts and thus the redistributional consequences. This also reduces the costs of bailouts for the fiscally sound countries compared to the current situation, giving these countries an incentive to adopt these common bonds.

Summarising the above discussion, introducing common bonds can indeed give countries the fiscal space to respond appropriately to the Covid-19 pandemic. This obviously benefits fiscally constrained countries. Common bonds can also be in the interest of fiscally sound countries who would benefit from an appropriate response and from avoiding bailouts that would take place without these bonds. The increased fiscal possibilities, however, also create a moral hazard of overspending and overborrowing.

To mitigate this, common bonds should be carefully crafted and limited to a temporary measure. Another relevant observation is that the introduction of common bonds does not require the introduction of a common EU tax instrument. Such an instrument can further stoke anti-EU sentiment, reinforcing the public backlash against redistributional transfers between EU countries.

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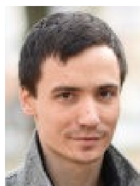

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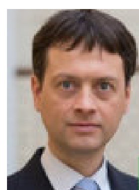

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