

1 September 2011

Framing the Eurobond

Erik Jones^(*)

German opposition to the Eurobond proposal is intense. Whether you poll public opinion or survey editorials in the popular newspapers, the answer is always the same. The German people do not want to be responsible for the debts of the Greeks, Irish, Portuguese, Spanish, or the Italians. They do not want to run the risk that they could have to pay back the loans taken out by countries that appear to have borrowed irresponsibly. And they do not believe their parliamentarians should be allowed to make a decision that would be too painful to reverse. Joining the single currency was bad enough; Germany will not join a European 'debt union'.

This position is as clear as it is irrational – at least from the perspective of those who support the Eurobond proposal. To begin with, the original idea of having a Eurobond was to create market incentives for highly indebted countries to rein in their spending. The proposal sketched by Italian Economics Minister Giulio Tremonti and Luxembourg Prime Minister Jean-Claude Juncker in a December 2010 editorial in the *Financial Times* offers good illustration. Countries would only be allowed to borrow cheaply in Eurobonds up to a certain share of their gross domestic product (GDP), they would get access to such borrowing under strict conditions, and they would commit to servicing those obligations first. Any additional borrowing would be much more expensive because it would be much riskier for investors. Hence there is an incentive for countries to stay within the limits.

More to the point, Germany is already exposed to significant losses in the event of a default by Europe's highly indebted countries, both directly and indirectly. In direct terms, German banks are the source of much of the lending at risk. German pension funds are heavily investing in now questionable sovereign debt as well. And Germany is a principal stakeholder in the European Central Bank, which holds the largest exposure of all. Indirectly, the German financial system is dependent on banks in other European countries for its funding; if those other banks take losses, German banks will have difficulties too.

Finally, the introduction of Eurobonds should lower the risk of default. Right now the highly indebted countries are struggling because they cannot get access to private capital at affordable interest rates. Greece, Ireland, and Portugal have already been pushed out of the market; Spain and Italy are paying dearly to stay in. The more these countries have to pay for their borrowing, the more likely they are to be forced to write down the principal of their debts. Greece spent most of the summer trying to avoid this outcome; now it appears to be inevitable. Market speculators are betting that other countries will soon follow. And that market speculation results in higher interest rates that in turn make some sort of default more likely.

In other words, German opposition to the Eurobond proposal is irrational from the perspective of Eurobond-supporters because the introduction of Eurobonds will increase fiscal discipline in highly indebted countries, shield Germany from losses on the borrowing that has already taken place, and weaken the

The opinions expressed herein are strictly personal and do not necessarily reflect the position of ISPI.

(*) Erik Jones, Professor of European Studies and Director Bologna Institute for Policy Research Paul H. Nitze School of Advanced International Studies (SAIS), Bologna Center, The Johns Hopkins University.

influence of speculation in the marketplace. But being irrational from one perspective does not make the German position irrational full stop. On the contrary, German opponents of the Eurobond say they fear such an instrument will force them to accept risks in the future; they would rather simply take their losses now than face that uncertain fate. For supporters of Eurobonds, the losses now appear large and the risks in the future appear smaller; for the Germans themselves the weights are the other way around.

This distinction between opponents and proponents of the Eurobond proposal may seem irrational but it is not. On the contrary, it is a fairly standard problem in behavioral economics – as demonstrated by Daniel Kahneman and Amos Tversky in their Nobel prize-winning research on ‘prospect theory’. [Only Kahneman received the prize in 2002 because the Nobel committee will not recognize scholars post-mortem; Tversky passed away in 1996.]

Kahneman and Tversky showed that people respond differently to losses and gains, even when the expected value of the outcomes is precisely the same. The idea is simple. When confronted with uncertainty about the risks involved, people will tend to exaggerate losses. In the Eurobond example, the Germans can raise any number of questions. How can we be sure that access to the bonds will be limited? What mechanism will be used to make sure that the highly indebted countries pay back their Eurobonds first? What will happen if investors take fright and stop refinancing these Eurobonds? Such questions give rise to uncertainty which only increases over time. As a consequence, the perceived risk that the Germans will have to cover losses on Eurobonds issued on behalf of Greece, Ireland, Portugal, etc., increases disproportionately. And psychological opposition to the Eurobond proposal increases as well. The Germans would rather cut their losses today than face the prospect of such exposure in an uncertain future.

For proponents of the Eurobond, the calculus works the other way around. Faced with precisely the same level of uncertainty, they focus on the concrete advantages in the present and pay less attention to the implications of future conditions. Here we should return to the point about fiscal discipline. Right now it is relatively easy for supporters of Eurobonds to discount the implications of constrained access to cheap bond financing. The most important point is to reduce the cost of debt servicing in the present. That is the immediate gain. The market discipline they will face in future public finances can be dealt with later.

The other insight from ‘prospect theory’ is that the emotions surrounding the fear of loss are stronger than those surrounding the prospect of gain. That explains why the Germans are so much more passionate in rejecting Eurobonds than anyone else is about supporting the proposal. It explains why the Germans are easier to mobilize and more vocal in expressing their opinions as well. Editors can sell more newspapers running against Eurobonds in Germany than writing in favor of them in Greece, Ireland, or Spain.

Turning this situation around will be a challenge. To begin with, European politicians will have to re-frame the German debate to emphasize the gains to Germany from the introduction of Eurobonds and to minimize the uncertainty surrounding potential future losses. This will require concrete concessions from highly indebted countries about their willingness to control spending in the future. The recent move to introduce formal constraints on debts and deficits into national legislation is part of this re-framing effort. Such constraints may not make much sense for a Keynesian economist, but they offer critical psychological support.

A more difficult part of the re-framing will be to convince the German people that the introduction of Eurobonds will result in gains. This will require concessions as well. What the Germans want to hear is that the highly indebted countries will fulfil their obligations. They want to see real evidence that existing sovereign debt will be paid back in full and on time. Such re-framing of the argument excludes the possibility for any restructuring – because restructuring means that creditors experience a loss and not a gain. Only a firm commitment to repay can change the terms of the debate.

Fortunately, the Eurobond proposals floated by Tremonti and others can meet both sides of this re-framing effort. They create a market discipline that is consistent with formal debt and deficit requirements and they lower the cost of debt servicing enough to make it possible for highly indebted countries to meet their obligations in full. The trick now is for European politicians to strengthen this message. They can change the terms of the debate. And once they do, they will discover that even staunch German opposition can be overcome after all.

La ricerca ISPI analizza le dinamiche politiche, strategiche ed economiche del sistema internazionale con il duplice obiettivo di informare e di orientare le scelte di policy.

I risultati della ricerca vengono divulgati attraverso pubblicazioni ed eventi, focalizzati su tematiche di particolare interesse per l'Italia e le sue relazioni internazionali.

Le pubblicazioni online dell'ISPI sono realizzate anche grazie al sostegno della Fondazione Cariplo.

**ISPI
Palazzo Clerici
Via Clerici, 5
I - 20121 Milano
www.ispionline.it**

© ISPI 2011