Jefferies European Economic Commentary

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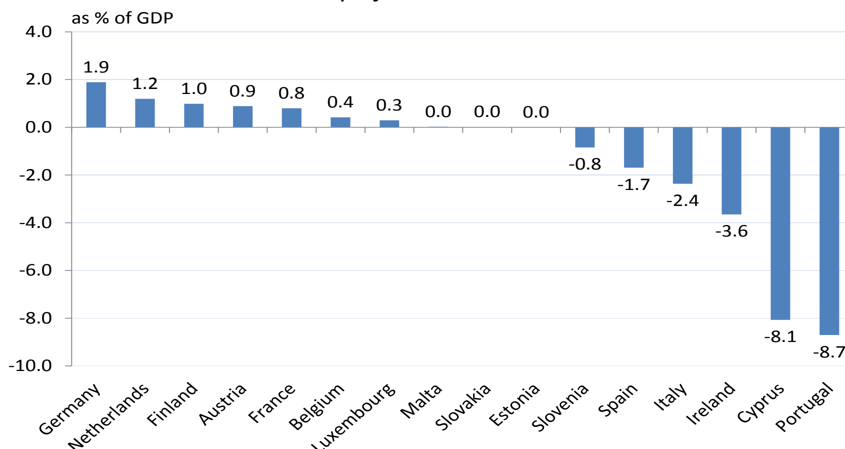
How much will the Eurobond cost Germany?

As we keep stressing, the decision of whether Greece stays in the euro will be made by the people of Greece and the politicians in Europe. The ECB's role will be as an observer. If there is political consensus, the ECB will continue to pump money into the country as it has done up until now – be it via its bond-buying Securities Markets Programme, LTROs, ELA (Emergency Liquidity Assistance – not to be confused with the ELO) and ultimately via larger and larger TARGET2 claims on the Greek Central Bank. The ECB's clear preference is for Greece to remain part of the euro, so Draghi would never pull the plug on the country's banking system and will certainly keep it going through next month's election.

As David Owen highlighted in his most recent note, Greece's bank deposit outflows are only really important because they are a taster of what might happen in France, Italy and Spain. The ECB can deal with any bank run by flooding the system with liquidity, but the problem is that if a country turns around and leaves the euro anyway, the remaining Central Banks will end up with a loss. Which is precisely why the ECB continues to press for solutions that do not place its capital directly in the firing line. In the near term, that means that the European Stability Mechanism (ESM) will be forced to take on a much bigger role in underwriting potential losses in the system (by guaranteeing all bank deposits across the euro area for instance), but ultimately the ECB will continue to push for the introduction of a common jointly issued Eurobond.

The idea divides our clients unlike anything else, but can the euro area really muddle through for the next two, or five, or ten years? Arguably not, because muddling through still involves more and more contingent liabilities for the governments in the core because of how the Eurosystem and the ECB is set up. So either the system splits apart or it is formally bound together, take your pick.

Annual cost/benefit of a common Eurobond from higher/lower government debt interest payments



Source: Jefferies International

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Here is a basic run down of one possible common Eurobond structure:

1) All euro area government debt gets issued jointly. At the moment, a basket of 10y euro area debt, weighted by the amount of outstanding debt yields 3.7% (see table on the next page). Greece's debt will almost certainly see further haircuts whether it stays in the euro or not, so we exclude it from the calculation.

2) Without an assumption of whether a common Eurobond would yield less or more than this 3.7%, some countries (Germany, France, Netherlands, Belgium, Austria, Luxembourg) will see their debt interest payments rise and the remaining countries will see these costs fall.

3) Germany currently funds at 1.4%. Under a common Eurobond, its rate of interest would rise to this 3.7% figure. The 2.3 percentage point increase in the rate of interest on the €2,088bn of outstanding debt equates to annual cost of ~€49bn (allowing for decimal points in the calculation in the table opposite). This €49bn figure is equivalent to 1.9% of German GDP. The chart on the front page shows the outcome of this calculation for each euro area country.

4) The biggest obstacle to Eurobonds is that there is no enforcement mechanism to guarantee countries which benefit from this fiscal transfer (Italy, Spain) won't run up unsustainable budget deficits. Most likely, the moral hazard argument can never be addressed entirely and any commitment to this project will take a certain leap of faith that governments behave responsibly. But there may be a way to try to address the potential problem if:

a) Eurobond is set up as a club that every country must earn the right to be part of. If a road map is laid out for them to be issued in say 2016, then each country may be forced to follow a program of structural reforms and to run a set of prudent budgets in order to be allowed to ultimately take part.

b) The Eurobond contract must be written in a way that allows countries to leave the Euro. So for example, if Italy misbehaves and gets kicked out, investors must be prepared to take losses on the Eurobond. Does that undermine the Eurobond as an idea? To a point, but the real purpose of a Eurobond is to provide stable funding for the countries that play by the rules, not to shield investors from potential losses. For instance, in five years' time, Italy may end up defaulting inside the Eurobond structure or outside it. The point is that a Eurobond decreases the likelihood of a default because it offers Italy funding at much lower rates – but only of course if its budgets are signed off by Brussels.

5) The Eurobond concept is far from perfect, but it will bind the euro project closer together. A commitment to a proper fiscal union also means the ECB will support the system in the interim. In terms of market dynamics, if a Eurobond concept was agreed to, then in theory there should be a convergence in yields towards this 3.7% (or 4%, or 5%) Eurobond yield level. But at the same time markets would still have to guess about who will meet the criteria to join, and who wouldn't. Which means the convergence play may be more complicated than it seems. A common Eurobond without Italy and Spain for instance, should obviously yield less than one with the two countries in it.

The arithmetic of a common Eurobond: who pays, who receives & how much

	2011 GDP (bn, euro)	Debt end 2011 (bn, euro)	Debt as % GDP	10y yield (%, latest)	Cost of a Eurobond relative to current borrowing rate (% pt)	Annual cost of a Eurobond subsidy (bn, euro)	Annual Cost of a Eurobond as % GDP
					(The difference between current sovereign 10y yield & assumed 3.7% yield on a common Eurobond)	(Level of Outstanding Debt * Higher/Lower borrowing rate)	
Germany	2,571	2,088	81.2	1.4	2.3	49	1.9
France	1,988	1,710	86.0	2.8	0.9	16	0.8
Italy	1,580	1,898	120.1	5.7	-2.0	-37	-2.4
Spain	1,073	735	68.5	6.2	-2.5	-18	-1.7
Netherlands	602	393	65.2	1.9	1.8	7	1.2
Belgium	369	362	98.0	3.3	0.4	2	0.4
Austria	301	217	72.2	2.5	1.2	3	0.9
Greece*	215	355	165.3	28.0			
Finland	192	93	48.6	1.7	2.0	2	1.0
Portugal**	171	184	107.8	11.8	-8.1	-15	-8.7
Ireland**	156	169	108.2	7.1	-3.4	-6	-3.6
Slovakia	69	30	43.3	3.7	0.0	0	0.0
Luxembourg	43	8	18.2	2.1	1.6	0	0.3
Slovenia	36	17	47.6	5.5	-1.8	0	-0.8
Cyprus**	18	13	71.6	15.0	-11.3	-1	-8.1
Estonia**	16	1	6.0	3.7	0.0	0	0.0
Malta**	6	4	72.0	3.7	0.0	0	0.0
				(average yield weighted by outstanding debt*)			
Euro area	9,414	8,218	87.3	**3.7**		**sum=0**	

* Calculation excludes Greece

** Countries where market yields are not representative

Source: Eurostat and Jefferies International

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