Special Eurobonds

Conditional Euro T-Bills as a transitional regime

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Introduction and summary

Since early 2010, tensions within the eurozone have risen sharply. A series of European summits has not been able to remove the doubts surrounding the future of the Economic and Monetary Union (EMU or eurozone) in its current form. It was only at the end of 2011 that the European Central Bank (ECB) was able to temporarily assuage the acute panic within the eurozone with its Long Term Refinancing Operations (LTRO) instrument. Nonetheless, during the following spring, tensions gradually returned to the eurozone. By now a Greek exit from the EMU seems to have become a matter of time. This could result in tensions spilling over into other countries and the ECB again having to pull out all the stops to stabilise the EMU. Meanwhile, the question of eurobonds has once again found its way to the top of the European political agenda. The problem is that the generic term 'eurobonds' conceals a multitude of variations. Some (e.g. Mario Monti) see the issuing of eurobonds as an instrument to stabilise the EMU. Others (e.g. François Hollande) would want to use eurobonds to boost economic growth. Others still (e.g. Angela Merkel) mainly consider eurobonds as a measure which would undermine discipline in weaker countries and which will push up interest rates sharply for strong member states. It is for this reason that German and Dutch political actors in particular are entirely opposed to the use of eurobonds. It is unfortunate that this discussion is generally not very analytical in nature. Rarely is the question raised of whether it might be possible to design a eurobond system in such a way as to boost stability and increase budgetary discipline while also offering tangible benefits to the financially stronger states. After all, everything depends on the way a eurobond programme is given shape.

Building on the work of Boonstra[1] (2011-b, 2012), this article proposes a temporary programme of short-term eurobonds (Euro T-Bills), launched by the European League for Economic Cooperation (ELEC). This proposal is a reaction to the 'green paper' on the topic published by the European Commission (EC 2011). It was presented in draft form in November 2011, and in its definitive form in January 2012 (ELEC, 2011, 2012). I argue that a temporary regime of conditional eurobonds, if well designed, can create long-term stability and present policymakers with the right incentives. The system would offer benefits to all participating countries and the ECB would be able to once again focus entirely on the execution of monetary policy.

[1] The author is indebted to the other members of the ELEC working party on eurobonds, viz., Graham Bishop, Michiel Bijlsma, Marko Bos, Niels Gilbert, Shahin Kamalodin, Rene Karsenti, Alman Metten, Franz Nauschnigg, Rene Smits and Nicholás Trillo Ezquerra. This article reflects the author's personal evolving views regarding the ELEC proposal. Special thanks to Shahin Kamalodin.

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Background

In late 2009 it came out that Greece had provided incorrect information about its government finances. In early 2010, German finance minister Wolfgang Schäuble suggested that this meant the Greeks would need to leave the eurozone. This triggered a process of monetary disintegration within the eurozone. Capital flight from the supposedly weaker countries to those in a stronger position put great pressure on the Economic and Monetary Union. Despite several European summits, during which meaningful steps were taken to strengthen European governance, the problems are not over yet.

By now, most countries in Southern Europe have seen new governments come to power which are expected to start up a credible process of reforms and restructuring. Nonetheless, they still have a long way to go before government finances will have been put in order sufficiently. After failing to form a stable government, Greece is facing a possible exit from the eurozone despite a considerable restructuring of the Greek national debt - in which bond holders accepted significant losses - as well as extensive support from the rest of Europe. In the first half of 2012, the member states put their budgetary plans to the European ministerial council for Economic and Financial Affairs (ECOFIN), after which implementation should follow.

At the start of the year, financial markets had finally been put at ease, which was due in large part to the European Central Bank (ECB). Its Securities Markets Program (SMP) allowed it to prevent interest rates for state loans in weaker member states from rising to unsustainably high levels. With the Long Term Refinancing Operation (LTRO), started in December 2011, the ECB has moved to issuing long-term (three year) liquidity to the banking sector. Through these actions it was able to assuage the worst stress in the markets, and buy politicians some time to implement the agreed measures. Fundamentally, however, nothing has changed yet. If the fragile sentiment on the financial markets turns negative again, there is a possibility that policymakers would not even have the time to convert their plans into policy. This danger became apparent in April and May of this year, for example, when tensions within the eurozone again rose sharply.

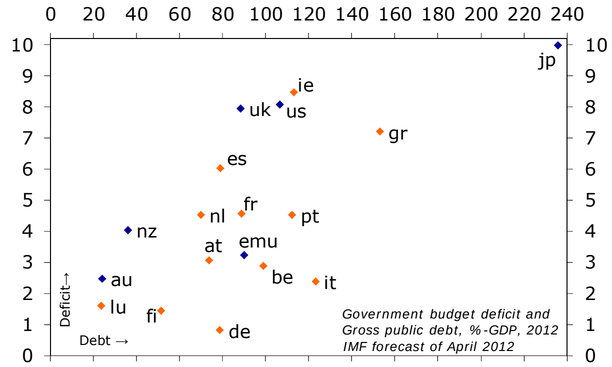
Within Europe, a majority is emerging in support of eurobonds as a tool to resolve the crisis. The problem with this, however, is that there has been a lot of noise around the topic for a number of years now, which has confused the issue. My argument is that the introduction of effective eurobonds can restore calm to the financial markets without introducing moral hazard. First, however, a definition is required of what makes eurobonds, effective eurobonds.

The EMU is financially strong…

… but was poorly designed

On average, the government finances of EMU member states compare favourably from an international perspective (Figure 1). Moreover, the current account of the eurozone balance of payments is more or less balanced. Therefore the EMU does not suffer from any significant savings deficit. Inasmuch as the EMU has a financial problem at all, in theory it should be able to solve this with its own means. What is clear, however, is that this external balanced situation conceals significant differences between countries within the EMU.

Figure 1: Government finances in an international perspective



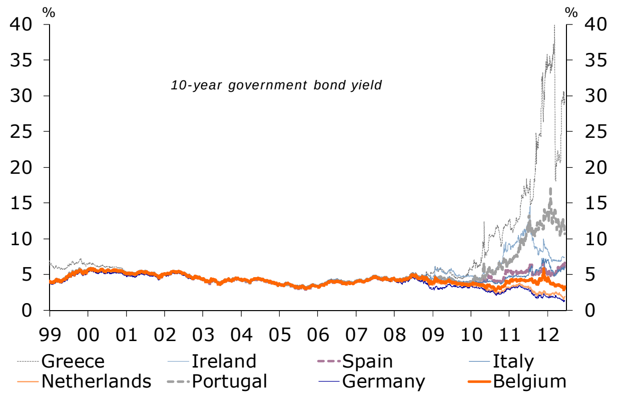
Source: IMF forecast of April 2012

Figure 1 shows that within the EMU the spread in government deficits and debts is considerable. The EMU contains a number of states with very weak government finances, as does the US, in fact. But in contrast to the US, the EMU does not have full political and economic union. There is no overarching budgetary policy, the member states' individual labour markets remain heavily segmented along national lines and the relative national debt and surplus positions are still sensitive subjects. Within the EMU, therefore, it is not the average quality of government finances that matters; instead, the weakest links have a disproportionately large effect on the EMU's overall strength. While this remains the case, which is moreover associated with fragmented bond markets and the absence of cross-guarantees, the EMU will not be able to extract itself from the danger zone. After all, financial markets have free rein within the eurozone and they may cause imbalances to spiral out of control to such an extent as to risk tearing the eurozone apart altogether. The Greek crisis has shown that even a small country (2.3% of EMU GDP in 2011) that finds itself in trouble can wreak havoc throughout entire eurozone. The fragmentation of bond markets means financial markets have the possibility of speculating against the continued existence of the eurozone. This fragmentation is the eurozone's design flaw.

The eurobonds debate

Eurobonds are bonds issued by a central European agency in order to finance the participating member states' national debt.[1] Although the first proposals to introduce eurobonds can be traced back to 1989, the debate has only switched to a higher gear since 2009 (Eijffinger, 2011). Eurobonds are also known as Stability Bonds (EC, 2011) or EMU Bonds (Boonstra, 1989, 1991; ELEC, 2011). They allow weaker member states to access funding for their sovereign debts at lower interest rates than the current market rates. Nonetheless, this carries the risk of removing a powerful external incentive for the countries in question to improve their fiscal policy. Because of this perceived moral hazard, the use of eurobonds has so far been rejected outright by Germany and the Netherlands. However, in the 1999 to mid-2008 period, the financial markets actually barely differentiated at all between strong and weak member states (Fig. 2). Therefore such an external incentive was in fact absent for a long time in any case. This meant policymakers were not being disciplined, harmful developments both in the realm of government finances and in the real economy were allowed to flourish, and the situation in a number of states became badly unhinged. The idea that strong euro countries are consistently rewarded with low interest rates therefore rests on a false assumption.

Figure 2: Differential eurozone interest rates



Source: Reuters EcoWin

Only after the collapse of the American investment bank Lehman Brothers did markets start to factor in differences in risk. After the Greek troubles started in the autumn of 2009, these differences became increasingly apparent. Therefore it was only in times of crisis that financially stronger states enjoyed more advantageous funding compared to weaker states. However, this advantage has been cancelled out almost entirely by the cost of the bailout packages, losses incurred on government bonds issued by problem countries and the costs of the recession in Southern Europe, which has impacted on the northern countries too. Given the hesitant response to the crisis and the tensions on financial markets, it remains to be seen whether policymakers will be given the time to adjust policies in the right direction. A well designed system of eurobonds could help to rein in financial markets. The problem is, politicians are quick to adopt outspoken positions in the debate surrounding eurobonds (whether for or against) without first asking questions such as: what do we want to achieve by introducing eurobonds? Is this feasible, and if so, under what conditions? This failure to analyse the situation is regrettable, because the common term 'eurobonds' hides a multitude of proposals with significant differences between them.

[1] Most proposals either implicitly or explicitly assume a type of agency which will issue Eurobonds. The French president François Hollande on the other hand has argued these should be issued by the ECB.

Criteria for eurobonds

I am personally of the opinion that before adopting a position regarding eurobonds, the question should first be asked which conditions these should meet and what the intended outcome would be. This involves the following points. First, if it wants to be successful, the eurobond programme should produce the effect that all countries be given access to funding under reasonable conditions. Second, and just as importantly, it should produce noticeable benefits for *all* participating states, i.e. it should not just help the weaker member states, but also offer advantages for the stronger ones. Only if this is the case will eurobonds enjoy broad political support. Third, it should have a disciplining effect on policymakers; it should not involve moral hazard but rather increase budgetary discipline where possible. Fourth, such a regime would preferably be self-funding, so that any possible problems in future might be addressed without having to bother the stronger member states with them (Boonstra, 2011-b, 2012). Fifth, a eurobond programme would ideally strengthen financial stability by breaking EMU member states' strong financial links between national governments and local banking systems. Last but not least, the eurobond programme should free the ECB of its interventions in the market for national debt. The ECB should be allowed to direct its attention back to its primary goal: the execution of monetary policy with the ultimate aim of maintaining price stability.

Only a eurobond programme which fulfils all these conditions would be acceptable to all member states. As of yet however, to a greater or lesser extent, most existing proposals do not meet these criteria. A solution to the problem of moral hazard might be found in the use of 'Conditional Eurobonds' (Muellbauer, 2011). These would reduce moral hazard through an internal allocation mechanism, with which states would finance their sovereign debt through a central agency, but they would pay this agency a premium on top of the agency's funding costs, depending on the quality of their government finances. This would provide the right incentives because good policy would soon translate into reduced premiums and vice versa. These premiums could be used to build up central buffers and to address any disappointing results. Further benefits of such a system for the stronger member states would include improved liquidity - and consequently, lower funding costs - and improved discipline for policymakers (Boonstra, 1989, 2012).

However, it is also important to realise that eurobonds are not a magic solution to all of Europe's financial troubles. After all, regardless of the programme's design, eurobonds do have their limitations as well. Most emphatically they are not an alternative to putting public finances in order and restoring competitiveness. At most, they might contribute to creating the circumstances under which such a policy of stability can be executed. Even with eurobonds, though, most EMU member states will need to put their government budgets in order. Eurobonds do not relieve them of the need to restore their competitiveness and potential for growth either.

Criteria for eurobonds

It should also be clear that a permanent eurobond programme cannot be put in place in the short run. The introduction of eurobonds represents a far-reaching redesign of the eurozone and this requires that time be taken to work out the details and complete all the necessary political, legal and constitutional procedures. This task should not be undertaken lightly. All the same, we are pressed for time: even though the ECB's LTRO 'bought' three extra years, financial markets could still spoil things. The developments of the last few weeks have certainly demonstrated that. This is why a working group from the European League for Economic Cooperation (ELEC) is proposing to start with a temporary programme (ELEC, 2011, 2012).

Euro T-Bills: a transitional regime

The ELEC working group proposes that those states which participate for the duration of the programme should be able to provide all the funding their governments need through collectively guaranteed short-term eurobonds (Euro Treasury-Bills). This guarantee should be a cross-guarantee, i.e. every member state guarantees the national debt of all other member states. Obviously, this is only possible when accompanied by a strict set of budgetary rules, to which participating countries would have committed, as well as effective and automatic sanctions for states that breach the agreements. Therefore the proposed T-Bill programme complements the new budgetary rules agreed upon in late 2011. Futhermore, not every member state will be able to participate from the start.

Conditions for participation are the following:

Only solvent states with approved policy plans can participate from the start

The programme is open to all solvent member states of the eurozone. This is understood to include all countries which have so far managed to get by without financial support from the other member states. Countries which are already in need of financial support (Greece, Ireland and Portugal) therefore cannot yet take part. The EFSF is open to those states; incidentally, should eurobonds be introduced, there would be no need to increase that fund. Only once these countries have brought their public finances in order, and have overcome their problems, might they qualify for entry. In addition to this, the intended policies of the participating countries must first have already been approved under the European semester. These policies should lead up to eventually fulfilling the criteria outlined in the Stability and Growth Pact (SGP). Finally it is essential that all the large states participate, including Germany.

Funding through short-term Euro T-Bills

Through the programme, participating countries can cover all their funding needs (financing deficit and due debts) over the next four years (2012-2016) through collectively guaranteed (cross-guarantee) short-term bonds (Euro T-Bills). These will have a maximum maturity of 2 years and will be issued by a new agency, the EMU fund. Participating countries would not issue any further short-term bonds themselves. However, they would be free to issue longer-term government bonds without a collective guarantee. Accordingly, if the programme were to be discontinued after four years, the last eurobonds would be repaid after six years, i.e. in 2018, at the latest.

Discipline through extra premiums

States whose budget deficit exceeds 3% and/or states with a national debt exceeding 60% of GDP would be liable to pay a premium on top of the necessary costs to finance the agency. This premium will vary according to an automated formula in which the relative size of the public deficit and debt is taken into account (see boxed text and figure 3).

Building up reserves
Through the premiums levied, the EMU fund would by definition make a profit as long as there are countries which do not meet the SGP criteria. This would be added to the agency's reserves. Thus, buffers are built up to resolve any possible future problem cases. These reserves are emphatically not meant to be used for bailouts, but rather intended as a cover for the collective guarantee on eurobonds issued. When the programme ends, and if a decision is made not to set up a follow-up programme, collected unused funds will be added to the capital of the European Stability Mechanism (ESM), the permanent fund currently being set up. If a follow-up programme does find support, the reserves created can, if desired, be passed on to the next eurobond programme.

Even if they have to pay a premium to the EMU fund, the weaker countries will still find this a cheaper solution than having to access the markets on their own. Note that the premium mechanism does, however, begin to discipline these countries much earlier than the financial markets have done in the past. Moreover, states can influence the premiums they are being charged by adjusting their policies in the right direction. Finally, the premiums paid to the EMU fund would be used to build up reserves, where the market's high interest rates would be collected as a risk premium by investors. At that time the stronger countries will find their costs will have gone up, but it should borne in mind that their current interest rates are unnaturally low due to their safe haven role within the eurozone.

Note that the buffers that have been built up should be placed at a distance from the political realm, in a situation analogous to the ECB.

Expulsion from the programme as an ultimate sanction
If states fail to implement the agreed policies, ultimately the decision could be taken to gradually phase them out of the programme. Obviously such a decision should not be taken lightly. States which do implement agreed policies cannot be blamed for a situation where results are do not meet expectations due to lower economic growth than had been foreseen, for example. Nonetheless there should be an ultimate sanction for states which do not live up to policy rules. In any case the programme does have a 'big stick' waiting at the end, as countries which behave badly can be excluded from participation in a follow-up programme, should this be decided upon.

Cross-guarantees prevent contagion
If a member state finds itself in financial trouble and does not wish to adjust its policy to conform with the indications given by 'Europe', it may be excluded from participating not only in the follow-up programme, but if necessary in the current programme as well. The cross-guarantees on already issued bonds, as well as the reserves that were built up to cover these, will prevent problems from spilling over into other states to a large degree. Therefore, compared to

the situation without eurobonds, those 'transgressors' are much less capable of wreaking havoc in the system, which will improve the EMU's bargaining position against unwilling countries considerably.

A temporary regime as a lead-up to a permanent solution

The temporary regime would ideally be followed up by a new temporary or even a permanent programme. However, in a permanent programme it would be much harder to phase out the transgressing countries. The temporary nature of the scheme proposed here, containing as its ultimate sanction the exclusion from a future follow-up programme, will therefore have a strong disciplinary effect and is thereby in itself an asset. The programme will however provide policymakers with enough time to show themselves capable of good governance.

Advantages and disadvantages

Advantages

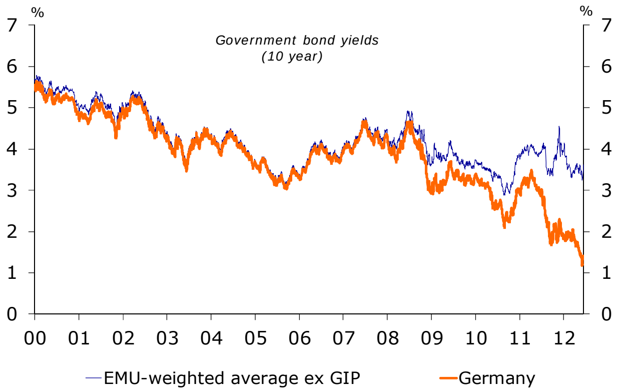
The temporary nature of the programme therefore provides a few major advantages in itself. One important benefit is that as it is temporary in nature, it can be introduced quickly. For the same reason, it can also be improved, should this prove necessary. It provides the opportunity of learning lessons along the way. Additionally it will allow Europe some time to carefully design any future system and to embed it in law. This is important as a thorough redesigning of the eurozone requires a broad political and social consensus. If a permanent eurobond programme does not function optimally after its launch, it will be extremely difficult to make changes to it, so for this reason alone a 'trial period' in the shape of a temporary programme would be desirable.

The programme's duration would allow states the time to get their policies in order without having to fear financial markets' reactions from day to day. Although the eurozone's problems can not be resolved within the space of four years, this period would provide enough time to design the right policies, implement these and demonstrate the policymakers' sincere intentions of executing them. As mentioned, the temporary nature would also offer a strong and credible sanction against countries which do not adhere to the agreed rules; they would not qualify for the follow-up programme. It is expected that this will have a strong disciplinary effect. The problem of moral hazard can be addressed by means of the premium levied in the internal allocation mechanism, and the possibility to phase a country out of the programme. At the short end of the yield curve, Euro T-Bills would be the only high quality paper available. This would also provide the EMU with its so-called risk-free asset as a collateral for transactions with the central bank. It would also offer the ECB the possibility to adopt a more traditional policy of quantitative easing without having to intervene in national markets for government debt should circumstances demand this.

The direct link between governments and their national banking systems would be severed by the introduction of eurobonds, as banks would mainly retain their liquidity in the shape of Euro T-Bills guaranteed by all member states. If one country's government lands in trouble, it will no longer drag the national banking sector down with it. This constitutes a major improvement on the current situation. Note that the ECB's operations, especially the LTRO, actually caused those ties to become a good deal tighter. Many banks used means provided by the ECB to buy local government bonds. In doing this they have contributed to some interest rate convergence within the EMU, but the potentially dangerous direct link between governments and their banking systems has been significantly tightened as a result.

The monetary union can be consolidated by the introduction of eurobonds, without more political integration than had been planned already on the basis of the agreed tighter governance of the eurozone. It is not just the weaker countries which will benefit, there are advantages for the stronger states too. Apart from the continuation of the EMU, the above mentioned self-funding character of the programme is the main advantage. As time progresses, the fund will build up buffers covered by the cross-guarantees. Should it then happen that a state is found to be lacking in servicing its national debt, at least all outstanding debt will be secure, without the need to come knocking on the doors of tax payers in financially more robust states at every incident.

Figure 3: EMU-fund versus German funding costs



Source: Reuters EcoWin, Rabobank calculations

A further benefit for stronger states concerns the expected liquidity premium. This is because the ample liquidity of the market for Euro T-Bills will result in lower interest rates due to these instruments' greater tradability. Assuming a modest liquidity premium of 25 basis points vis à vis the yield (weighted by national debt) on two-year sovereign loans within the eurozone, then in normal circumstances even the Netherlands and Germany would very probably find themselves with lower costs (ELEC, 2012).

Importantly, our calculations are not based on the current yield on Dutch and German government bonds. The current, extremely low interest rates are unrealistic and unsustainable, because they are the result of a flight to safe havens within the eurozone. This means that regardless of its design, any solution to the euro crisis would result in an interest rate increase for Germany and the Netherlands, as the safe-haven effect will disappear. Nonetheless, the perception that eurobonds will automatically result in a higher interest rate for financially stronger states is unfounded. The following figure will illustrate this for German 10-year government bonds by means of a proxy for the funding costs of the EMU fund. The proxy was constructed as a weighted average (by sovereign debt) of the member states' interest rates.

This figure, like figure 2, illustrates the fact that between 1999 and mid-2008, even Germany did not benefit from any noticeable funding advantage compared to the (weighted) average of interest rates within the eurozone. Greece, Ireland and Portugal were not included in this calculation as they initially would not qualify for participation in the Euro T-Bill programme as contained in the ELEC proposal. It was only after 'Lehman' that any differentiation began to manifest itself on the financial markets and not until the pinnacle of the euro crisis, in the autumn of 2011, did the difference became substantial. However, in this period, the funding advantage was to a large extent, if not entirely, cancelled out by the costs of the bailout packages, losses incurred on portfolios, and the costs of the recession in Southern Europe which naturally was hardly a welcome development for exporters in the north. In short, the cost advantage for stronger countries is often exaggerated - it was absent for most of the time. Also note that, even if the ELEC T-Bill programme is launched, participating states can issue government bonds themselves if they are so inclined, although this would only be possible for the longer maturities.

Disadvantages

There are disadvantages too, although these are limited. Should the unwelcome step be necessary of phasing out a member state, this will cause unrest. However, given that the other states will be able to continue participating in the scheme, the chances of a serious risk of contagion are slim. After all, market participants will no longer be able to speculate against the continued existence of the EMU by bringing individual countries into acute liquidity problems. These countries would still be safe under the umbrella of collective guarantees. Therefore the bargaining position of transgressor states would *de facto* be seriously undermined by the introduction of eurobonds. Where Greece initially considered its bargaining position to be strong because of the justified fear of contagion regarding other eurozone members should the country have to leave the Euro, this would no longer be the case under the proposed Euro T-Bill programme.

Another disadvantage is that weaker participating countries, in particular, which will not yet be able to issue long-term bonds themselves, would finance their deficits and their maturing debt with short-term credit. This means the average maturity of their national debt would decrease, which will increase their public finances' sensitivity to interest rates. Therefore it is advisable to extend the maturities in a follow-up programme, should the scheme be successful and a successor programme be put in place.

Finally, the formula needed to calculate the premiums must be determined (see boxed text).

Box 1: The size of premiums additional to the funding costs of the EMU fund

The premium will be calculated using the following formula:

$R(i) = \alpha\,[DEF(i) - DEF(m)] + \beta\,[DEBT(i) - DEBT(m)]$

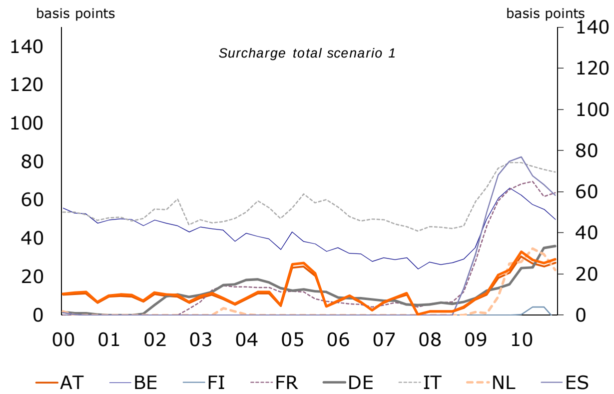
in which:

R(i) = the size of the premium additional to the funding costs of the EMU fund.
DEF(i) = the budget deficit of country i, as a percentage of GDP
DEBT(i) = the national debt of country i, as a percentage of GDP
DEF(m) and DEBT (m) are the maximum values for budget deficit and national debt described in the SGP, i.e. 3% and 60% of GDP respectively.
Parameters α and β are coefficients determining the relative weight of national debt and the budget deficit in the formula.

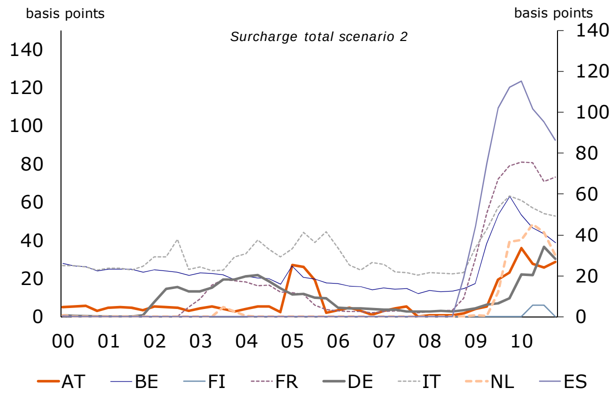
Advantages and disadvantages

Determining parameters α and β will be the outcome of a political bargaining process. These should be set in advance, be uniform for all states and participating countries should subscribe to them at the moment of accession. There are two key questions to consider in setting the parameters. First, the size of the premiums has to be determined. This is important for the disciplinary effect and for the speed at which the buffers can be built up. Second is the question of whether premiums should primarily be built up based on the size of the national debt, or on the basis of the budget deficit. The second option is preferable here, as it will allow the premiums to react strongly to changes in fiscal policy. A rising budget deficit would swiftly be punished with rising premiums, but a change in direction would be rewarded equally fast. This embeds effective incentives. As mentioned above, determining the formula is a one-off process, as opposed to the many ad hoc negotiations which have caused Europe to limp from one incident to the next in recent years. Countries should commit to this in advance, before they accede to the system. Figure 4 illustrates two scenarios.

Figure 4: Premiums in the EMU fund in two scenarios (2000 – 2011)



Source: Reuters EcoWin, Rabobank calculations



Source: Reuters EcoWin, Rabobank calculations

Footnote: This figure is a simulation of how these ratios would have progressed had eurobonds been introduced from the start. They are based on the factual development of deficit and debt levels on a quarterly basis (related to SGP criteria). In scenario 1, more weight is given to debt ratio (α = 0.10 and β = 0.010). In scenario 2, relatively more weight is given to the developments in budget deficits (α = 0.15 and β = 0.005).

What are the alternatives?

When discussing the positions for and against the use of eurobonds, too little attention is paid to the question of what other options are available. Opponents who argue that eurobonds would remove the pressure on policymakers to put their affairs in order make a valid point to the extent that many eurobond proposals lack any mechanism to prevent moral hazard. However, that has been addressed in this proposal. And opponents who argue that eurobonds will not resolve the real problem, that of poor budgetary discipline in the eurozone, are entirely correct. The main function of eurobonds is to create an environment in which policy proposals can actually be realised. They can stabilise the markets and give the ECB some space to direct its attention back to its core function: monetary policy. However, they are by definition complementary to agreed budgetary measures and do not replace them.

But what is the way forward if we decide against introducing eurobonds? In that case, it must be feared that the eurozone will experience much deeper crises over the coming months and years than the current one. Implementing policy takes time and markets will not be prepared to wait. Financial markets would still be free to speculate against the continued existence of the euro and will continue to target one supposedly weaker state after the next. Consequently, every problem, even in the smallest of member states, immediately becomes an EMU-wide problem, because it puts renewed pressure on the eurozone. Until at some point, something has to give and one or more countries are forced out of the eurozone. The ECB can keep matters under control to a certain extent through its Securities Markets Program (SMP) and the LTRO, but in doing so it is building an increasingly unbalanced portfolio, and its position between monetary and budgetary policy is becoming increasingly blurred, and harder to accept for the Germans. In reality, the ECB's measures in some ways resemble the use of eurobonds (buying weaker states' bonds backed by guarantees from the collective, namely its shareholders), but in an opaque way and lacking in democratic legitimacy. This should not be taken as criticism of the ECB. However, its behaviour underlines the weakness of the actions of Europe's politicians.

Conclusion

The introduction of a four-year Euro T-Bill programme as proposed here would give policymakers time to implement good policies and to consider a permanent reform of eurozone governance. The temporary nature of the programme is an important asset. Many of the proposed eurobond programmes contain more than a few elements which will clearly harm the stronger member states. In most cases, for example, they do not deal with moral hazard, or they contain as yet untested elements, begging the highly legitimate question whether they might not lead to undesirable effects when put into practice. Consider for instance the blue bond/red bond proposal launched by the Brueghel think-tank (Delpla & Von Weizsäcker, 2010) or the idea proposed in Germany to put a so-called redemption fund in place. The disadvantages of such schemes are not just the insecurity they imply, but once in place, it will prove extremely hard to make any changes to them at all. The advantage of the temporary nature of ELEC's Euro T-Bill programme is that it will be possible to accumulate some experience with eurobonds as an instrument, which can prove itself in this period. Any desired changes can be included in a follow-up programme. No further increases to the EFSF would be needed, because in this scenario it would only be open to Greece, Portugal and Ireland. Once the new fund also takes over most of the portfolio of weaker states' government bonds accumulated by the ECB after a certain time, and places these in the eurobond programme, the central bank will once again be able to focus its energy on its core task: monetary policy with the ultimate goal of combating inflation, complemented of course by the task of guarding financial stability.

After four years, the Euro T-Bill programme could, if desired, be converted into a permanent eurobond programme covering all maturities. However, the decision could also be taken to extend the programme, and possibly to extend the life of eurobonds by a few years to a maximum of three or four years. In that case the ultimate sanction, not being permitted to participate in a follow-up programme, would still be a very credible threat on the horizon. Should the programme be less successful than hoped for, and should the decision be taken not to extend it, then we may well have lost one illusion, but we would not be in a worse position than we find ourselves in today.

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