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The crisis in the Eurozone: the current situation and perspectives

This paper explores ideas for the implementation of systematic decisions of how to structure sovereign debt system in the EU and avoid future sovereign debt crisis. The two main difficulties that arise in a framework of the "European bonds" are how to ensure further sustainability of EU sovereign debt management (especially for high-debt countries) and how to convince virtuous countries to support the project and reduce the debt service costs. This paper suggests an approach for dealing with those issues, although this area clearly requires further work. While this paper concludes that the "European bonds" is a novel approach for improving sovereign debt management that is worthy of further research, it is only the first pass at the issue, and further research is needed before arriving at a definite conclusion. In fact, while bringing more benefits for countries with high debt levels, the ideas of the "European bonds" may become contradictory to the countries with the effective debt management practices. In any case, it will help to prevent future overborrowing and sovereign debt crisis. Moreover, an overall judgment of the "European bonds" will depend on the further development of sovereign debt management decisions of the EU institutions. The increase of EU countries sovereign debt is the pending scientific problem leading to the search of complex solutions needed for overcoming present sovereign debt crisis and restoring the trust of Euro as a currency of all European Union. The aim of the paper is to analyze the reasons of the present EU sovereign debt crisis and to assess the "European bonds" as possible measure for solving the EU sovereign debt control problem. Research methods applied – analysis of scientific papers and statistical data.

Kryzys w strefie euro: aktualna sytuacja i perspektywy

W artykule przedstawiono możliwości restrukturyzacji zadłużenia w UE i uniknięcia kryzysu długu publicznego w przyszłości. Wprowadzenie obligacji europejskich wymaga rozwiązania dwóch głównych problemów: zapewnienia stabilizacji zarządzania długiem publicznym w UE (zwłaszcza w krajach o wysokim poziomie zadłużenia) oraz przekonania krajów niezadłużonych do poparcia projektu i zmniejszenia kosztów obsługi długu. W artykule przedstawiono istniejące możliwości dotyczące zarządzania długiem publicznym. Autorzy artykułu twierdzą, że obligacje europejskie mogą przyczynić się do wzrostu efektywności procesu zarządzania długiem publicznym, jednak zagadnienie to wymaga dalszych badań. Obligacje europejskie są bardziej korzystne dla krajów o wysokim poziomie zadłużenia i mniej korzystne dla krajów, które efektywnie zarządzają długiem publicznym. Obligacje europejskie pozwolą uniknąć nadmiernego zadłuże-

nia i kryzysu długu publicznego w przyszłości. Ogólna ocena obligacji europejskich zależy od decyzji podejmowanych przez instytucje UE dotyczących zarządzania długiem publicznym. Wzrost zadłużenia państw UE jest ważnym zagadnieniem z punktu widzenia naukowego, którego analiza prowadzi do znalezienia kompleksowych rozwiązań, dzięki którym rozwiązany zostanie kryzys zadłużenia UE, a jednocześnie zostanie przywrócone zaufanie do euro jako waluty wszystkich krajów Unii Europejskiej. Celem artykułu jest analiza przyczyn obecnego kryzysu długu publicznego w UE i ocena obligacji europejskich jako potencjalnej metody rozwiązywania problemów dotyczących zarządzania długiem publicznym. Stosowane metody badawcze to analiza literatury naukowej oraz danych statystycznych.

Keywords: sovereign debt, sovereign debt crisis, debt structuring, European bonds.

Introduction

After the financial crisis, economies with existing deficits usually are in danger to go to default due to uncontrolled borrowing paces. All the members of the European monetary union have violated treaty limits on allowable budget deficits – some of the members have four times larger deficit. Such a development clearly suggests that some countries in the European Union might become insolvent since their net external debt is really a large measure to the size of their economies. After the financial crisis, economies back to the recovery after the period of 3 to 4 years. Therefore, the rate at which economies are shrink or grow is very slight. Due to these processes, it is really a big challenge to bring these deficits back to satisfactory level. Governments then have to go to the market and ask for additional debt to cover its deficit. These countries, if not aided, will possibly default and will be forced to restructure their debt. This argument is the reason why the European Commission and prime ministers of the European Union make a lot of play on discussions about present and future sovereign debt issues, not only regarding the certain countries, but the entire EU.

The Italian Finance Minister Giulio Tremonti and Luxembourg's Prime Minister Jean-Claude Juncker, in an article which appeared in the Financial Times on 5 December, launched the proposal to issue the "European bonds". In this paper, authors follow this idea and appeal to obvious arguments showing that the "European bonds" would be a great cooperation to control the Euro zone debt. Authors also consider the "European bonds" as a tool to solve the EU debt crisis and ensure future financial stability of all the EU countries. The idea of the "European bonds" is not new. The first one goes back to Jacques Delors in the 1980s. Jacques Delors proposed to issue similar bonds in addition to the European Investment Bank loans to finance infrastructure investments; so the initial idea was intended to provide a new debt instrument for financing pan-European infrastructures, but recently the idea of the "European bonds" has become the possible measure for overcoming present sovereign debt problems.

The article focuses on such cases of the sovereign debt crisis as unbalanced sovereign budgets, irrational social and public spending, too high trust of creditors, etc. Theoretical assumptions of development of debt structures and description of "debt dilution" phenomenon are provided in the second part of the paper. Long recognized as a problem in corporate debt, dilution seems to have recently become a significant problem in sovereign debt markets. Debt dilution has undesirable consequences for both debt structures as well as the amounts and terms at which sovereigns borrow. Special attention is paid to the need for reforming EMU governance, by which financial markets judge success of both sovereign – debt restructuring and implementation of the "European bonds".

1. Sovereign debt crisis: fundamental features

The history shows that financial crises are generally followed by sovereign debt crises. In some cases, the sovereign debt crisis become the reason of the currency crisis. The latter stage is not the case for the EU, because of an existence of the Euro zone and currencies pegging mechanisms. From the point of view of sovereign debt crisis, some four stages of a typical debt crisis appearance could be indentified:

1) growing deficit
2) growing debt
3) downgrades of financial ratings
4) default.

The first stage of the sovereign debt appearance is a deficit growth, and it is the outcome from the financial crisis. During the financial crisis, government spending increases dramatically in attempts to stabilize the financial system and stimulate economic activity. The cyclical income from taxes goes down, but the government's financial commitment stays mostly unchanged. Social and health affairs, huge and important state infrastructure projects usually cannot be stopped on the spot. Therefore, fiscal surpluses become deficits. If the financial crisis damages the banking system and government must borrow huge sums from the market, then the situation becomes even more difficult. Thereby, economies with existing deficits are in danger to go to default due to uncontrolled borrowing paces. All the members of the European monetary union have violated treaty limits on allowable budget deficits – some of the members have four times larger deficit. Even leading economies of the world have all seen their deficits become higher; some of them to a record level (Figure 1).

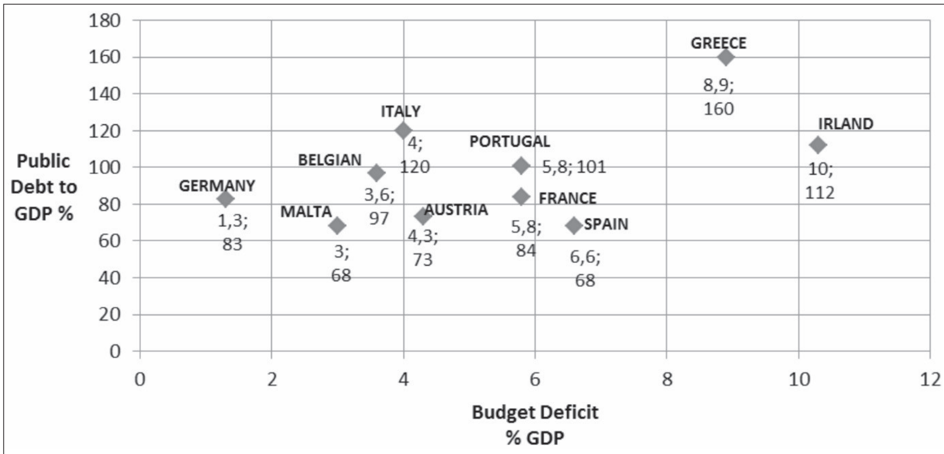

Fig. 1. Budget Deficit and Public Debt to GDP in Eurozone 2011

Source: [Eurostat, EU – Commission, 2011].

In line with the EDP, the Lithuanian budget for 2011 aimed at a deficit of 5.8% of GDP. On the back of an improved macro-economic the forecast underlying the 2011 Convergence Programme, the government reduced its deficit targets to 5.3% of GDP in 2011 and 2.8% in 2012. To meet budgetary targets, the government relies on a strong revenue growth, partly due to a better tax compliance, and some increases in non-tax revenue, which mainly relate to a higher inflow of the EU structural funds [*European Economic Forecast*, 2011].

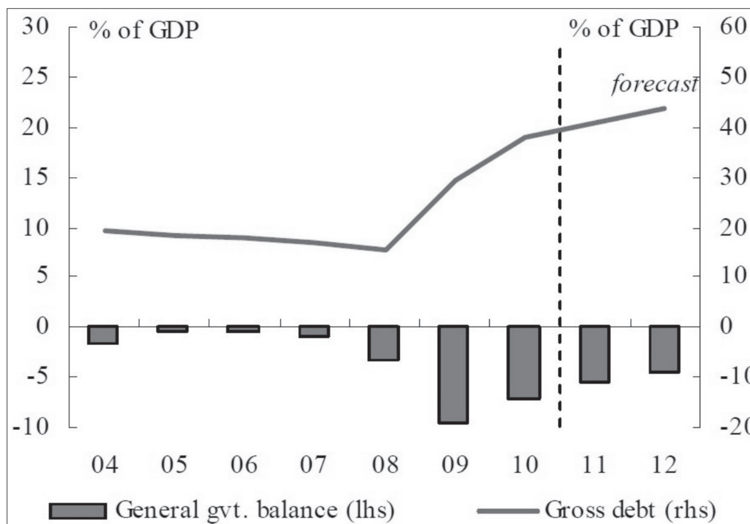

Fig. 2. Lithuania's General government balance and gross debt

Source: [*European Economic Forecast*, 2011].

The next sovereign debt appearance stage is a growing debt. Almost in every financial crisis, economies are back to the recovery after the period of 3 to 4 years. It means that government's budget starts to collect more taxes after business and private individuals start to receive more profit and income. Therefore, the rate at which economies shrink or grow is very slight. Due to these processes, it is really a big challenge to bring these deficits back to a satisfactory level. Governments then have to go to the market and ask for additional debt to cover its deficit. This stage leads into growing debt loads.

That means that governments have to cut spending, raise taxes and divert revenues to payoff interest on their debts. Furthermore, because of the worries of a default, investors are demanding higher interest payments before lending any more money. The risk premium raises rates on assets, such as corporate bonds, which means that companies themselves find it more expensive to borrow. Deep budget cuts result in a freeze of public sector wages, impact pension reforms, and lead to an increase in fuel taxes. Usually (but not always) when debt reaches 80 percent of GDP, the borrowing costs for governments start to increase. Markets become suspicious and suspenseful. There are some interesting parallels between the experience of the Baltic States and the current situation in the eurozone periphery. The peripheral eurozone countries have lost market access and their banking sectors are facing difficulties in accessing foreign finance.

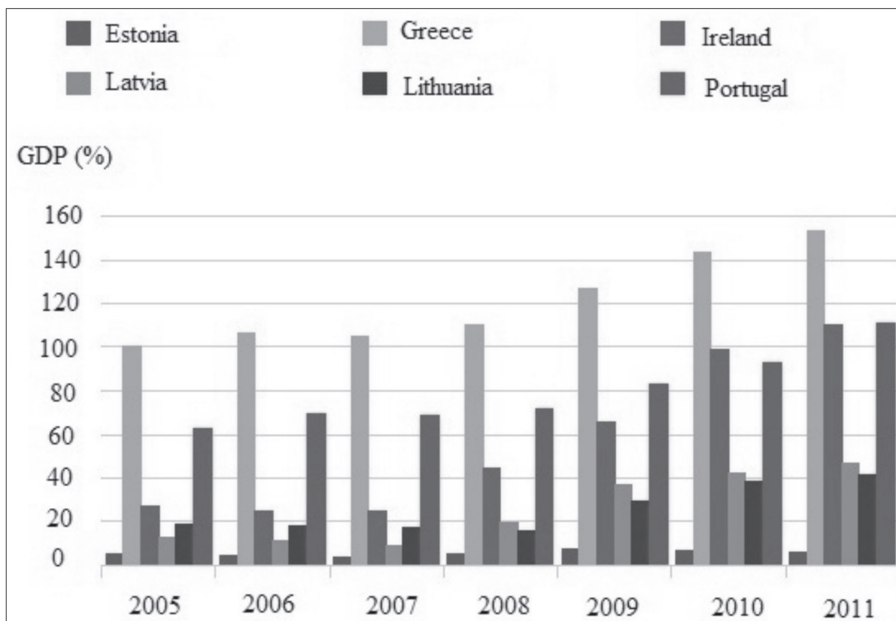

Fig. 3. Sovereign Debt

Source: [*The Euro Zone Crisis*, 2011].

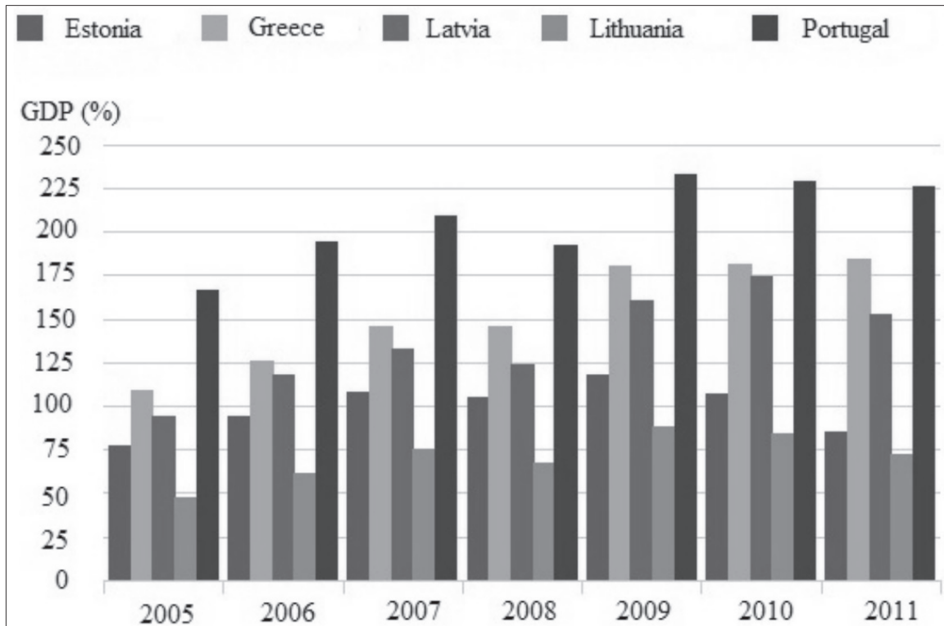

Fig. 4. Gross External Debt
Source: [*The Euro Zone Crisis*, 2011].

Information provided in Figure 3 and Figure 4 demonstrates that the Baltic countries had lower public debt ratios to GDP and their general government budgets were closer to balance with the expectation of Ireland in the past (2005 – 2008). External indebtedness was also lower in the three Baltic countries [*The Euro Zone Crisis*, 2011].

If the second stage mentioned above goes up, then the third stage, i.e. downgrades of financial ratings will become real. When deficits and debts rise and economic activity appears to be too weak to solve fiscal problems, the credit worthiness of the government falls under intense scrutiny. This moment is always fixed by watchful international rating agencies. This stage, in a short term period, is not avoided in every sovereign debt crisis, because the restructuring of countries problems takes at least two years. Even the best rating holders, like Ireland and Spain, lost the rating due to a decreased trust and believe that countries are able to serve the present and future commitments to markets. If some essential changes in debt crisis decisions will not appear during near future, downgrades are going to be a great trouble [Cole, Kehoe, 2000; Gros, 2010].

A default is the final and the most negative stage of the financial crisis. Downgrades only start the cycle of weak economic activity and growing dependence on debt. When markets indicate higher risk, the more return will be definitely required. Therefore, the borrowing costs for these troubled countries rise. Then it

becomes harder to finance spending needs and harder to finance existing debt. Even a huge rescue package committed by the EU and IMF does not ensure the long-term solvency of Greece, Portugal and other EU countries. Even Spain, an economy that represents 12 percent of GDP for the euro zone might be the next in line for a massive funding request. At this stage, a deliberate political and financial decision must be enacted to step out from the debt crisis [Rich, 2010].

2. Theoretical assumptions of the development of a debt structure

In analyzing the existing debt structures, two sets of comparisons provide insights into how debt structures might be improved. First, a comparison between debt structures in less advanced countries and advanced economies highlights the characteristics that make advanced economies less crisis prone. Compared with advanced economies, less advanced countries find it relatively difficult to issue long-term debt in their own currencies. A greater reliance on short-term and foreign currency debt is associated with a higher frequency of asymmetric shocks and sovereign debt problems. Short-term debt (or debt indexed to short-term domestic interest rates) is associated with vulnerability to sudden changes in the market sentiment: worsening perceptions of the country's creditworthiness can quickly feed into higher interest costs, often leading to vicious circles. Similarly, with relatively large shares of the foreign currency debt, depreciations can abruptly render a country insolvent. Only a handful of the largest economies issue debt denominated bonds in their own currency on international markets, perhaps reflecting in part their economic size and the use of their currencies as a vehicle for international trade. Bonds issued internationally are otherwise relatively homogeneous, usually taking the form of fixed-rate bonds with relatively long maturities. By contrast, the composition of debt issued domestically varies considerably across countries [Missale, 2009; Reinhart, Rogoff, Savastano, 2003].

Less advanced countries' difficulties in issuing long-term local-currency bonds on the domestic market seem to result from deeper problems, such as the lack of monetary and fiscal policy credibility (in EU especially for not member countries of the Euro zone), and related worries about the possibility of inflation. Regarding the debt issued internationally, some international financial institutions (IFIs) have often been among the first parties to issue bonds denominated in the currencies of less advanced countries (usually in the combination with the exchange rate swaps with emerging market residents that issue in one of the world's main currencies). Opportunities to raise funds at more favorable rates have been, and should continue to be, the primary motivation for the IFIs' involvement in these operations: the IFIs have been able to tap new investor bases interested in

holding assets denominated in less advanced currencies but bearing no default risk. This said, contributions to the development of new financial markets that can later be tapped by developing countries are a welcome by the product of such funding decisions by the IFIs.

The ideas for sovereign debt structurising came from the corporate context. An explicit seniority partly as a result of contract enforcement issues, sovereign liability structures both in less advanced countries and in advanced economies are not as rich as those of the corporations. A notable difference is the a lack of an explicit seniority structure, which, at the corporate level, exists either by statute or through bond covenants. As a result, sovereign creditors tend to be more exposed to "debt dilution" than do their corporate counterparts. Debt dilution occurs when new debt reduces the claim that existing creditors can hope to recover in the event of a default. Long recognized as a problem in corporate debt, dilution seems to have recently become a significant problem in sovereign debt markets. Debt dilution has undesirable consequences for both debt structures and the amounts and terms at which sovereigns borrow. Its adverse effects on the debt structure stem from investors' efforts to hold debt forms that are harder to dilute – such as short-term debt or debt that is costly to restructure. Such instruments, in turn, make the debtor more vulnerable to crises and render the impact of crises more severe. Dilution also increases the likelihood that highly indebted countries will over borrow. Countries near default may be able to place new debt with investors without facing prohibitive interest rates, as the new creditors effectively obtain a share of the existing creditors' debt recovery value. At low debt levels, the opposite problem may occur, as the possibility of dilution tends to raise interest rates unnecessarily. In principle, debt dilution could be ruled out by an explicit, "first-in-time" seniority structure giving priority to earlier debt issues, because in the event of bankruptcy the original creditors would be repaid first. The first-in-time seniority would tend to reduce borrowing costs at low debt levels, but make borrowing more expensive at high debt levels. In fact, if the probability of a debt crisis were substantial, markets would expect a new debt issue to be junior to most outstanding debt in the event of a crisis, and thus demand a higher interest rate compared to the present system. The effect on borrowing costs would reward prudent borrowing behavior and discourage over borrowing. An explicit seniority could also improve debt structures by reducing incentives to issue "crisis-prone" debt forms that are hard to dilute. An explicit seniority would also entail risks, however. In particular, an unavoidable consequence of limiting dilution and making new borrowing harder at high levels of debt is that this may prevent some countries from accessing debt markets in situations of illiquidity, in turn increasing the likelihood of liquidity crises. Another potential drawback is that seniority could complicate debt pricing and, as a result, make debt more expensive (at least until markets be-

came familiar with the new system). Uncertainty would be increased by the possibility that sovereigns find ways to circumvent seniority when their borrowing levels are elevated, for example, by obtaining direct bank loans under different jurisdictions or providing collateral for subsequent loans [Borensztein et al., 2004].

3. The reform of the Eurozone institutions

The Eurozone crisis offered a critical juncture for the reform of the euro area institutions to set in place the provisions to help avoid a similar occurrence in the future. The scope for reform was constrained, however, by a concern as to whether it required a change to the EU treaties. Given the debacle of constitutional reform stretching over most of the previous decade, there was little political will amongst most governments to attempt such changes.

The first steps to reform were taken in the context of the Ecofin agreeing on 9 May 2010 to establish a rescue mechanism (the 'European Financial Stability Fund') to prevent any threats to the euro from unsustainable debts accumulated by the member governments. The mechanism involved the creation of a fund of €750 billion, seen by its advocates as akin to 'shock and awe' to overcome market doubts.

The debate on the reform gathered momentum. There was some confusion in the process as the European Council in June established a task force of the 27 finance ministers under its President, Herman von Rompuy (to report to its next meeting on 28–29 October), the Commission advanced its own proposals and the ECB urged changes. An early consensus was reached on the need to revise the treatment of the national debt levels. The European Council signaled that it sought a revision of the SGP's 60 percent rule on debt, so that penalties would not automatically apply and the focus would be whether the trend was downward and sustainable. Without such a change, 12 EU states would be in breach of the existing rule. Moreover, a new discussion emerged on whether to include both public and private debt, with implications for national performance. If both were included, then Spain would be found to be a 'sinner' and Italy 'virtuous'; if just the former, then the reverse would be the case. A further consensus was reached on the notion that the EU states were to review each other's draft annual budgets during the so-called 'European semester' .This was scheduled to begin in January 2011.

In response to the Greek crisis, the German government was now using the language of 'economic governance' that its predecessor had swept aside prior to Maastricht. Yet, the substance of its position stressed 'preventive' and 'corrective' measures with the prospect of tougher monitoring and sanctions – notions consis-

tent with the traditional 'ordo-liberal' philosophy. Just as at Maastricht, Paris was at pains to move ahead in tandem with Germany and their bilateral axis appeared to have been revived by the crisis. The two finance ministers – Christine Lagarde and Wolfgang Schauble – presented a joint paper on 'economic governance' on 21 July 2010. It envisaged the option of neutralizing an errant state's voting rights in the Council of Ministers and of obliging it to make an interestbearing deposit with the Commission. Such reforms might be made under the 'enhanced co-operation' mechanism of the Lisbon Treaty allowing nine or more EU states to make progress in an area without waiting for the rest. However, the German instinct was for the changes to be sanctified by a treaty revision, possibly at the time of the Croatia's accession.

At the end of September, the Commission presented its proposals covering sanctions, fiscal monitoring and reporting, and broader economic surveillance. Crucially, the package of six legislative proposals did not require treaty changes. The Commission saw the Stability and Growth Pact (SGP) as becoming more 'rules-based'. A reverse voting mechanism in the Council would mean that the Commission's proposal for a sanction would be considered adopted unless it was voted down by a qualified majority. A similar notion had been advocated by the ECB. For states with 'significant' deviations from the 3 percent deficit and/or the 60 percent public debt rules of the SGP, a new sanction would require them to make an interest-bearing deposit. Failure to take corrective action – and the application of the 'excessive deficit procedure' – would mean the payment of a noninterest-bearing deposit equal to 0.2 percent of GDP. This would be converted into a fine in the event of a non-compliance. The interest earned on the deposits and fines would be transferred to the virtuous euro members not in breach of the rules [Featherstone, 2011].

To try to avoid fiscal deviations, the Commission would monitor the positions of member governments by reference to the concept of 'prudent fiscal policy-making' and the steer of a 'medium-term objective', issuing warnings where necessary. Debt trends would be followed more closely (being placed on an equal footing with the deficit focus) and errant states would be expected to reduce it at a rate of one-twentieth of the divergence with the 60 percent threshold over the previous three years. A new directive setting out minimum requirements was proposed to ensure that the national fiscal budgets followed consistent rules of accounting, statistical reporting, forecasting, fiscal rules, budgetary procedures and fiscal relations with other public bodies such as regional or local authorities [Regulation 1467/97].

The Commission also advocated that it should have a greater role in monitoring macroeconomic imbalances. A new regulation would involve constructing a regular scorecard of economic indicators, with the option of launching in-depth

reviews of the Member States seen as vulnerable, leading to the possible application of a new 'Excessive Imbalance Procedure' (EIP) for those states putting the operation of EMU at risk. The states in the EIP and flouting the Council's recommendations would have to pay a yearly fine equal to 0.1 percent of its GDP. Again, only 'reverse voting' in the Council could block the application of the fine [Featherstone, 2011].

The Commissions package also followed the lead of Germany and others to strengthen the 'automaticity' of the sanctions, while also advancing the capacity of the 'centre' to monitor national conditions. In doing so, it was endeavouring to overcome the limitations on its own role established in the Maastricht Treaty and to make a bureaucratic grab for power.

The Commission's proposals were soon attacked. Those who had found the Maastricht design of EMU too narrow derided the fact that sanctions were being strengthened without the necessary institutional innovations of economic governance. The ability of the Commission to impose fines against a democratically elected government was questioned, as was the notion of *ex ante* validation of national budgets. Moreover, the Commission was accused of short-termism in the horizons it envisaged for imbalances to be adjusted.

Beyond these prevention and punishment ideas, a wider debate opened up on creating new institutions and resources at the EU level. The 'European Debt Agency' was supported by the Party of European Socialists as a means of facilitating future debt management and defending the Eurosystem against speculative attacks. An earlier idea had been to create a common euro bond, with each state participating according to its capital share in the ECB. Profligate states would have to pay a higher interest rate than others. Ideas like these assumed a will to deepen a political union that was not evident. Similarly, notions of expanding economic governance to include much stronger supply-side reform commitments – an agenda put aside in the Maastricht negotiations – as contained in the Lisbon 2000 and 'Europe 2020' programmes seemed unlikely.

4. The EU sovereign debt crisis ride out: a "European bonds" solution

Recent decisions by the European fiscal and monetary authorities on sovereign debt issues continue to destroy the weak economic recovery. Strong-minded and versatile decisions must be formulated to global markets to restore trust in the EU [Juncker, Tremonti, 2010; Imarketnews Update, 2010]. The Italian finance minister, Giulio Tremonti and Luxembourg's Prime Minister Jean-Claude Juncker, in an article which appeared in the Financial Times on 5 December, launched the

proposal of establishing the European Debt Agency (hereinafter – EDA), which should replace the European Financial Stability Facility, when this expires in 2013. Each country through EDA could issue "European bonds" up to 40% of GDP – thus well within the Maastricht reference rate of 60%. It would create, over time, a sovereign bond market of similar size to the US treasury market. As a first step, the EDA would finance 50% of member states' debt issues – but this can be raised to 100% during crises (Fig. 5) [Eurointeligence, 2010].

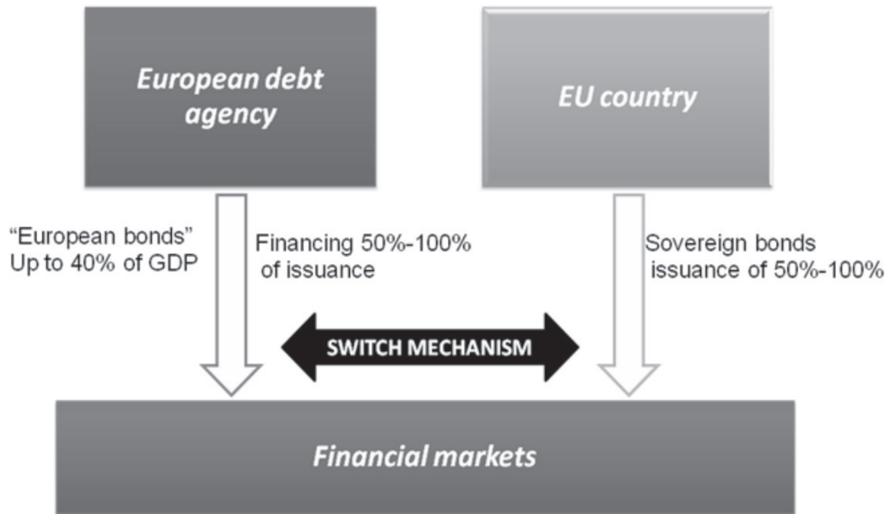

Fig. 5. The scheme of the „European bonds“ operation
Source: [prepared by the authors].

The recent proposal has some features of "Exchange Offers". The main idea is that the sovereign debtor, threatening to default, proposes to the creditors that they accept "voluntarily" the new bonds in exchange for the existing securities. The new securities are worth less, but are senior relatively to the old ones, as they are given priority in the repayments. If well planned, the offer may be convenient for creditors, who, by accepting it, lose less than they would by refusing and prompting a default. The offer is clearly convenient for the sovereign debtor, since it reduces the value of his debt and allows him to continue to access the international capital markets at reasonable rates. This procedure, however, does not require an international guarantee, as in the case of the Eurobonds. More importantly, the conversion of old into new debt makes sense only if made as soon as possible, i.e. before default [Manasse, 2010]. The second aspect of the "European bonds" is the mechanism of the switch between the national and "European bonds". This is the built-in default mechanism [Eurointeligence, 2010].

The conversion rate would be at par but the switch would be made through a discount option, where the discount is likely to be higher the more a bond is undergoing market stress. Knowing in advance the evolution of such spreads, the Member States would have a strong incentive to reduce their deficits. The "European bonds" would halt the disruption of sovereign bond markets and stop negative spillovers across national markets [Juncker, Tremonti, 2010]. This would solve the problem of low liquidity in the secondary sovereign market, because during the crisis almost all EU sovereign bonds are not sufficiently liquid [Eurointeligence, 2010].

In the absence of well-functioning secondary markets, investors are weary of being forced to hold their bonds to maturity, and therefore ask for increasing prices when underwriting primary issuances. So far the EU has addressed this problem in an ad hoc fashion, issuing bonds on behalf of the Member States only when their access has been seriously disrupted. A new market would also ensure that private bondholders bore the risk and responsibility for their investment decisions. In this way, the "European bonds" proposal usefully complements recent decisions aimed at providing clarity about a permanent mechanism to deal with debt restructuring. It would help to restore confidence, allowing markets to expose losses and ensuring market discipline. Allowing investors to switch the national bonds to the "European bonds", which might enjoy a higher status as collateral for the ECB, would help to achieve this. The bonds of the Member States, with weaker public finances, could be converted at a discount, implying that banks and other private bondholders immediately incurred the related losses, thus ensuring transparency about their solvency and capital adequacy.

A "European bonds" market would also assist the Member States in difficulty, without leading to a moral hazard. The governments would be granted access to sufficient resources, at the EDA's interest rate, to consolidate public finances without being exposed to short-term speculative attacks. This would require them to honour obligations in full, while they would still want to avoid excessive interest rates on borrowing that is not covered via the "European bonds". The benefits from cheaper, more secure funding should be considerable. A liquid global market for the "European bonds" would follow. This would not only insulate countries from speculation but would also help to keep existing capital and attract new flows into Europe. It should also foster the integration of the European financial markets, favoring investment and thus contributing to growth.

Ultimately the EU would benefit too. Profits from conversions would accrue to the EDA, reducing effective "European bonds" interest rates. As a result, the EU taxpayers, and those Member States currently under attack, would not have to foot the bill. All these benefits could be extended to Member States that remain outside the Euro zone [Juncker, Tremonti, 2010].

From the history point of view, the proposal of Giulio Tremonti and Jean-Claude Juncker is not new. The original one goes back to Jacques Delors in the 1980s [Manasse, 2010]. Jacques Delors, at that time, prospective French Minister of Finances proposed the issue of the "Union bonds", whose repayment would be guaranteed by the Community budget, in addition to the European Investment Bank loans to finance infrastructure investments in transport, energy and telecommunications. Jacques Delors economic adviser Stuart Holland, envisaged the issue of the Union bonds by the European Investment Fund as a vehicle for the transfer of a substantial share of Member States' national debt to the Union. After such "tranche transfer", the Member States would continue to service their share of their debt, but at a lower interest rate. Stuart expected the bonds not to count as debt of the member states, by analogy with US Treasury bonds, but because the Member States would continue to service them that analogy does not hold. Actually, the initial idea was intended to provide a new debt instrument for financing pan-European infrastructures [Nuti, 2011].

Nowadays, post-financial crisis situation is different, and sovereign debt issues have to be managed. Therefore, Giulio Tremonti and Jean-Claude Juncker version is also different and applied for today's situation. In their opinion, a new European debt instrument should gradually replace national public debts. But recently the IMF is arguing that the EU should not concentrate on individual initiatives, but go for a larger programme, because the EU economy suffers from a systematic problem. A German Finance Minister, Wolfgang Schaeuble has told that financial markets are currently not speculating against individual EU countries but rather doubt the sustainability of the European Monetary Union as a whole.

Conclusions

Giulio Tremonti's and Jean-Claude Juncker's proposal is probably a single most important proposal ever made since the outbreak of the European sovereign debt crisis. The scheme for single "European bonds" comes in different sizes and forms, but all proposals have an underlying consideration in common: the "European bonds" would attract a lower interest rate than the average (weighted) interest rate at which the nation states could borrow in international markets, because of the lower liquidity premium and the lower credit risk premium.

The funds raised through issues of single "European bonds" could be channeled to the Euro zone Member States in various ways: by buying their new national bond issues, or by buying back old national bonds, or by lending to member states against the security of domestic bonds [Nuti, 2011].

The Sovereign debt crisis is a cyclical process due to systematic problems (mostly irrational budgeting or large social spending programs). In order to overcome debt crisis, the EU needs the systematic view and coordination. Therefore, Giulio Tremonti and Jean-Claude Juncker in some way have advanced Jacques Delors' idea and applied it as a mechanism of financial stability in the EU.

EU politicians and experts acknowledge that the "European bonds" could possibly be only the part of a whole rescue package and that the creation of the EU crisis solvency mechanisms, more tough control from the IMF and ECB, larger the EFSF program, because the existing EU rescue funds won't be large enough, should be considered by the EU more carefully. An increase of the EFSF funds is a more likely scenario than the issuance of the "European bonds".

The Tremonti-Juncker project is a good idea for financing infrastructure and increasing market liquidity in good times. Yet, it requires a large loss of the fiscal sovereignty by high debt countries. Because of its timing, it's a bad idea for solving the debt crisis of Europe. Further analysis would also be needed on how to overcome potential legal and practical obstacles to introducing contract-based seniority. Nevertheless, given the potential benefits of an explicit seniority for the crisis prevention and other enhancements to the bond contracts that would also mitigate debt dilution, this paper calls for further analysis and discussion of the issue.

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