MARKETS

EU Pushes Scenarios for Euro Bond

As Rescue-Fund Expansion Falters, Idea Is Floated; but Germany Opposes

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BRUSSELS—As the euro zone's debt crisis threatens to draw in more victims and a plan agreed to expand the currency's bailout fund looks set to disappoint, the European Union's executive arm will this week float proposals for joint issues of bonds among the currency's 17 governments.

WSJ's Charles Forelle reports European leaders are once again considering the issuance of bonds to help raise capital in light of the Eurozone's debt crisis. Photo by Sean Gallup/Getty Images

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The proposal to end the crisis from the European Commission calls for the euro zone to use its combined strength in the bond markets to replace some or all of the fund-raising currently being done by national governments.

The proposals for common bond issues are unlikely to gain traction soon: Germany, the strongest economy in the common currency, remains resolutely opposed to the idea, fearing it would be stuck with the bill for other governments' spendthrift ways. But the commission's discussion document appears designed to trigger debate on one of the few ideas that economists think offers the prospect of ending the crisis.

The commission's proposal to create euro bonds reflects how critical is the search for a lasting fix to the euro-zone debt crisis, given the failure of the bloc's temporary patches. Most critically, confidence is waning that the European Financial Stability Facility, the temporary fund set up in the wake of Greece's bailout, will ever achieve the heft needed to reassure investors financing weak euro-zone governments that their lending is safe.

The commission discussion paper suggests three options for issuing euro bonds. It concludes that they could be issued carrying limited guarantees from governments without changes to the European Union treaty that would require ratification from all 27 EU states. But it says that the benefits would be greater if all governments agreed to jointly guarantee bonds issued by the euro zone—but this would require changes to the treaty.

The least ambitious option would yield fewest benefits but could be implemented relatively quickly and could mark a step on the road toward the more ambitious approaches that would need treaty changes, the paper concludes.

Three Visions of Euro Bonds

National bond issuance ceases. Euro-zone governments raise new funds in euro bonds, guaranteed jointly by all 17 members. Existing bonds are converted into euro bonds.

National governments raise funds as euro bonds, guaranteed jointly by the 17 members, up to a certain limit. Beyond that, governments issue national bonds.

National governments raise funds as euro bonds up to a ceiling. Unlike in the first two options, the bonds are backed by limited guarantees from the 17 euro-zone states.

—Source: European Commission

In a sign of how European officials are looking for other approaches to handle the debt crisis, they are exploring plans to pool representation of euro-zone nations into a single seat at the International Monetary Fund, a move that could boost the currency bloc's clout and reshape a battle for power at the institution. "The euro area will be strengthened because it speaks with one voice," Viviane Reding, a vice president at the commission, said in an interview.

The 40-page paper from the commission, which has been reviewed by The Wall Street Journal, is due for official release on Wednesday. It highlights the danger that issuing euro bonds could weaken budget discipline among euro-zone governments and says that issuing such bonds would require new safeguards to tighten budget discipline and improve economic competitiveness, some of which would also require treaty changes.

The first option it discusses would be to substitute all national issues by governments with euro bonds carrying what it calls a "joint and several" guarantee, meaning that euro-zone states would pool the credit risk and each government would agree to guarantee the debt of every other government. Under this approach, all new government bond issues would be euro bonds, and existing national government bonds would be converted into euro bonds.

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The second option would be to partially substitute national issuance with euro bonds up to a limit, of say 60%, of a country's gross domestic product, or up to a ceiling that could change depending on how closely the government complied with euro-zone rules. These bonds would also be jointly and severally guaranteed. Beyond that limit, governments would still have to issue national bonds.

Those two options would require treaty changes, because they contravene the current treaty's clause forbidding one government from bailing out another, but the third option wouldn't. This third approach would have euro bonds replace some national bond issues—but the euro bonds would receive guarantees from each government only up to specific limits.

The quality of the bonds issued under option three could be further improved by providing collateral, such as cash or gold reserves, or earmarking tax revenues, the paper says.

This approach, the paper says, would "deliver fewer of the benefits of common issuance but would also require fewer preconditions to be met." These bonds would be unlikely to carry interest rates as low as those issued with joint guarantees.

The paper concludes that the third option "seems to be more easily ready for rapid deployment." But it would be introduced along with a road map to further development of the instrument along the lines of the first option, together with the stronger rules necessary to ensure that euro bonds with joint guarantees weren't abused by national governments.

The paper is issued as an agreement among euro-zone governments to use financial engineering to expand the EFSF, which has fallen short of early expectations that it might be able to muster as much as €2 trillion ($2.7

trillion) to backstop its wobbly giant Italy.

The EFSF, after subtracting its current and expected commitments to Greece, Ireland and Portugal, has between €250 billion and €300 billion available. That's less than a year's borrowing for Italy.

In recent weeks, the EFSF has been sounding out potential investors about two options to increase the fund's capacity to perhaps €1 trillion.

One is to use the fund's money to provide partial insurance on bonds issued by weak governments. The other envisions raising a big fund from outside investors, in which the EFSF would take a minority stake and suffer the first losses, which could be used to support weak countries.

But the EFSF hasn't raised any of these outside funds, and its chief has said he doesn't expect to do so before the end of the year. Many European officials doubt the approach is viable on a large scale, and Friday Dutch Finance Minister Jan Kees de Jager said it appeared unlikely to happen.

Instead, Mr. de Jager suggested in comments to a small group of reporters, "probably the IMF route will be used by some countries."

But it isn't an easy route either. The International Monetary Fund itself has available resources roughly comparable to the too-small EFSF, and there is great political reluctance in non-euro countries to increasing the IMF's size in order to help Europe.

That leaves the first option, partially insuring governments' bond issues. In theory, it could provide enough comfort to investors to permit them to continue lending to Italy and Spain. But it has several pitfalls.

First, as with the other leverage option, the amount that can be brought to bear is inversely proportional to the intensity of the crisis: If the crisis is particularly acute, potential investors will demand higher levels of insurance from the EFSF. Since the EFSF's resources are fixed, the volume of bonds it can insure would fall.

Second, the insurance can only practicably be attached to bonds newly issued by governments—the so-called primary market. But there is great disturbance in the secondary market, where investors sell bonds to each other. That couldn't be directly ameliorated by the insurance plan, and the secondary-market volatility is a major reason why investors are leery to buy debt from weak governments--they don't know at what price they'd be able to get rid of it if they need to.

Euro-zone finance ministers are scheduled to meet next week in Brussels; the bailout fund will be a top topic of discussion. In a worrisome development for the EFSF, the fund itself has suffered a stumble in investor confidence, likely reflecting worries both about its second-biggest guarantor, France, and about the fund's own future structure.

A bond the EFSF issued earlier this month to fund part of its bailout for Ireland, for instance, required a much higher premium to garner enough investor interest. And even since the issue, the bond has lost value. Friday, on the Luxembourg bourse, it closed 3.4% below the price at which it was issued.

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