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Eurobonds and the European Debt Trilemma

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Abstract

A well-designed European sovereign debt architecture should avoid debt mutualization, create a large safe asset, and reduce the risk of self-fulfilling crises. This note derives a European debt trilemma, showing that no feasible architecture can simultaneously achieve all three objectives. The note then develops a simple model to evaluate the Blanchard and Ubide (2025) proposal. The model establishes a safety condition justifying the 25 percent replacement threshold, average cost neutrality as a consequence of Modigliani–Miller, and, most importantly, strengthened fiscal discipline at the margin, since the rate on national bonds is strictly more sensitive to domestic fiscal conditions than the rate it replaces.

Keywords: Eurobonds; European Safe Asset; Fiscal Discipline; Debt Seniority
JEL Codes: F34; F36; H63; E44

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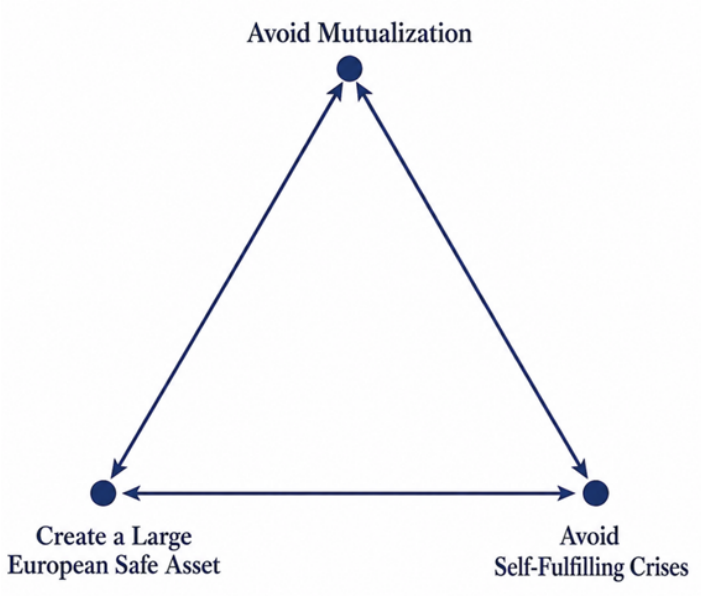
1 Introduction

A well-designed European sovereign debt architecture should satisfy three properties. First, it should avoid debt mutualization, preserving national fiscal responsibility and limiting moral hazard. Second, it should create a large, liquid, and safe European asset capable of meeting global demand for a dollar alternative and anchoring the eurozone's financial architecture. Third, it should reduce the risk of self-fulfilling debt crises, which can push solvent sovereigns into default through coordination failures among investors.

The current system prioritizes the first objective: national bonds are issued independently and mutualization is avoided.[1] However, the eurozone lacks a deep safe asset, and individual sovereigns remain exposed to self-fulfilling crises. The debate over European safe assets is, at its core, a debate about how to move beyond this corner solution.

Figure 1: The European Debt Trilemma



[1]Some observers argue that this characterization overstates the degree of national independence, because large-scale asset purchases by the European Central Bank under programmes such as the Securities Markets Programme, the Outright Monetary Transactions facility, and the Transmission Protection Instrument have introduced an element of implicit mutualization: the risk associated with national sovereign bonds has been partially transferred to the ECB's balance sheet and, through it, to all member states. Brooks (2025) argues that each successive ECB intervention of this type moves the eurozone closer to a synthetic eurobond, with the TPI in particular functioning as a de facto yield cap that backstops weaker sovereigns.

Blanchard and Ubide (2025) propose replacing up to 25 percent of GDP of EU member states' national debt with jointly issued senior eurobonds, backed by a legal commitment from each country to transfer a dedicated share of tax revenues to service the eurobond tranche.[2] The goal is to create a deep, liquid, and safe European bond market capable of competing with the US Treasury market, while explicitly avoiding debt mutualization. Lustig (2025) suggests that this proposal weakens fiscal discipline by decoupling borrowing costs from national fiscal conditions. This note develops a simple model that shows that this is not the case: because the eurobond tranche is fixed and any additional borrowing takes the form of national bonds, the marginal cost of borrowing is strictly *more* sensitive to domestic fiscal conditions than under the current system. The Blanchard–Ubide proposal therefore achieves two of the three desiderata, avoiding mutualization while creating a large safe asset, and it does so while strengthening rather than undermining fiscal responsibility. The proposal is not without risk, however. Precisely because marginal borrowing becomes more sensitive to domestic fundamentals, it could in principle increase the vulnerability of national bond rates to self-fulfilling crises.

An alternative approach is the European Debt Agency (EDA) proposed by Amato et al. (2024). The EDA would issue bonds on capital markets and on-lend the proceeds to member states through perpetual loans priced according to a fundamentals-based formula that differentiates rates by country creditworthiness. Because pricing is idiosyncratic rather than pooled, the authors argue that no mutualization occurs. At the same time, by insulating sovereign financing costs from market sentiment and speculative dynamics, the EDA would reduce roll-over risk and the threat of self-fulfilling crises, while the safe-asset status of EDA bonds would address the shortage of high-quality euro-denominated collateral. The proposal thus claims to resolve all three corners of the trilemma simultaneously.

The key vulnerability of the EDA mechanism is that its model-based pricing, however transparent in design, is not immune to manipulation. If the formula used to assign credit risk classes or calibrate transition matrices can be influenced, whether through political pressure on the agency, through regulatory capture, or through the inherent model uncertainty that surrounds any such exercise, the differentiation across member

[2]See also Blanchard and Ubide (2026). Precursors to the Blanchard-Ubide proposal include the Blue Bonds/Red Bonds proposal of Delpla and von Weizsäcker (2010). The Appendix provides a brief literature review, which also covers the ESBIEs proposal by Brunnermeier et al. (2011) and Brunnermeier et al. (2017)

states could be compressed relative to true creditworthiness. In that case, safer countries would implicitly subsidize riskier ones, and mutualization would re-enter through the back door.

Figure 1 illustrates these trade-offs. The Blanchard–Ubide proposal achieves the first two objectives: avoiding mutualization and creating a large safe asset. The EDA proposal targets the second and third: creating a safe asset and reducing self-fulfilling crisis risk, but at the risk of implicit mutualization once the fragility of model-based pricing is taken into account. The three objectives may therefore constitute an *impossible trinity*, in which any feasible architecture can achieve at most two.

Ultimately, the design of possible policy reforms depends on which of the three objectives illustrated in Figure 1 one considers most important. No single reform dominates across all three dimensions: each addresses certain risks more effectively while accepting greater exposure to others. What is clear is that the Blanchard–Ubide proposal represents a robust improvement over the status quo for anyone who does not regard the increase in self-fulfilling crisis risk as prohibitive.

This note develops a simple model to clarify three questions. First, what is the maximum safe eurobond threshold? Second, what is the effect of eurobonds under the Blanchard–Ubide proposal on average borrowing costs? Third, and more importantly, what are the implications of the proposal for fiscal discipline, that is, for the sensitivity of the marginal cost of borrowing to domestic fiscal conditions? The model delivers three main results.

The first result is a **safety condition**: the maximum eurobond threshold that guarantees full repayment even in a default event is $t^* = s(1-h)$, where s is the debt level below which default risk is zero and h is the haircut in default. For plausible calibrations this justifies the Blanchard–Ubide target of 25 percent of GDP.

The second result is **average cost neutrality**. As discussed in Blanchard and Ubide (2026) to first order, the eurobond reform leaves average borrowing costs unchanged. The saving on the senior eurobond tranche (financed at the safe rate) is exactly offset by the higher rate on the junior national bond tranche, which now bears the full concentrated default risk. This result is a direct application of the Modigliani–Miller theorem (Modigliani and Miller, 1958): repackaging the same underlying cash flows into senior and junior claims leaves total financing costs unchanged, just as altering a firm's capital structure does not affect its total value in frictionless markets.

The third result concerns **fiscal discipline**. A critique of eurobonds holds that they

weaken fiscal discipline by decoupling borrowing costs from individual fiscal conditions: the eurobond rate reflects collective rather than individual creditworthiness. The model shows that this critique conflates the average rate with the marginal rate. Since the eurobond tranche is fixed and any additional borrowing takes the form of national bonds, the relevant fiscal signal is the national bond rate. The model proves that this rate is strictly *more* sensitive to domestic fiscal conditions than the plain vanilla rate it replaces. Eurobonds therefore *strengthen*, not weaken, fiscal discipline on the margin that matters.

2 Setup

There is a continuum of countries indexed by their debt-to-GDP ratio $d \in [m, M]$, where all variables are expressed as shares of GDP. The distribution of debt across countries is given by a CDF $F(d)$ with density $f(d) > 0$ on $[m, M]$. There is a safe debt threshold s: this is the debt level at which sovereign finances are fully sustainable. Debt above s is risky and markets penalise it through default risk.[3] I assume $m \ll s \ll M$, so that some countries are well below the safe threshold s and others are well above it.

2.1 Default risk

Definition 1 (Default probability)**.** The default probability of a country with debt d is:

$$\pi(d) = \begin{cases} 0 & \text{if } d \leq s, \\ \lambda(d-s) & \text{if } d > s, \end{cases} \tag{1}$$

where $\lambda > 0$ is the marginal default risk per unit of debt above s.

Remark 1. The model takes default probabilities as exogenous and does not formally capture self-fulfilling dynamics. The discussion of the third corner of the trilemma is therefore qualitative and draws on the broader literature on multiple equilibria in sovereign debt markets (De Grauwe and Ji, 2013; Dell'Erba et al., 2013; Lorenzoni and Werning, 2019).

[3] While I assume that s is constant across countries, one could model it as country-specific, based on fiscal capacity or GDP volatility. In that case, the safety condition would require setting s equal to the minimum value across the euro area.

In the event of default, bondholders recover a fraction $1 - h$ of face value, where $h \in (0, 1)$ is the haircut. A country with total debt d that defaults repays $d(1 - h)$ in aggregate.

2.2 The safe interest rate and the liquidity premium

There is a safe interest rate $i > 0$, reflecting the return on zero-default-risk sovereign debt of limited market depth (e.g., the current Bund rate). I later introduce a **liquidity premium** $\ell \geq 0$, so that the eurobond rate in a deep and liquid market is:

$$r^{\mathrm{E}} \;=\; i - \ell, \qquad \ell \geq 0. \tag{2}$$

In the baseline, I set $\ell = 0$. Section 7 extends the model to $\ell > 0$. All debt is refinanced every year, so rates are reset annually.

3 The Eurobond Proposal

Each country issues up to t units of GDP of *eurobonds* at rate r^{E}. Eurobonds are senior: in default, eurobond holders are paid first. Debt in excess of t is issued as *national bonds*: purely domestic obligations that are junior to eurobonds. For a country with debt d:

$$d \;=\; \underbrace{\min(d,\, t)}_{\text{eurobonds (senior)}} \;+\; \underbrace{\max(d - t,\, 0)}_{\text{national bonds (junior)}} .$$

I focus on countries with $d > t$. Countries with $d \leq t$ issue all their debt as eurobonds and face no additional complexity. Blanchard and Ubide (2025) suggest a target of $t = 0.25$ (25 percent of GDP), which at the eurozone level would generate approximately €5 trillion of eurobonds. Section 4 derives the model-consistent maximum safe threshold.

4 The Safe Threshold

In default, a country with debt d repays $d(1 - h)$ in aggregate. Since eurobonds are senior, they are paid first. Eurobonds of face value t are fully covered if and only if:

$$t \;\leq\; d(1 - h). \tag{3}$$

This must hold for every country with positive default probability, i.e., for all $d \in (s, M]$.

The binding constraint comes from the country with the lowest debt that may nonetheless default — the country with d approaching s from above:

$$t \;\leq\; \lim_{d \to s^+} d(1-h) \;=\; s(1-h).$$

Proposition 1 (Maximum safe threshold)**.** *The maximum eurobond threshold that guarantees full repayment in a default event is:*

$$\boxed{t^* \;=\; s(1-h).} \tag{4}$$

Any $t \leq t^*$ is safe; any $t > t^*$ exposes eurobond holders to losses in the event of default by the marginal country.

Remark 2. t^* is increasing in s and decreasing in h. In the limit $h \to 0$, the entire sustainable debt s can be converted to eurobonds. For $s = 0.60$ (the Maastricht ceiling) and $h \leq 0.58$, the formula justifies the Blanchard–Ubide target of $t = 0.25$. Table 1 shows the safe thresholds under different assumptions for s and h.[4]

Table 1: Safe Thresholds for Selected Values of s and h

	$h = 0.30$	$h = 0.40$	$h = 0.50$	$h = 0.60$
$s = 0.60$	0.42	0.36	0.30	0.24
$s = 0.50$	0.35	0.30	0.25	0.20
$s = 0.40$	0.28	0.24	0.20	0.16

Remark 3. Crucially, the same condition $t < s$ that ensures safety is also the condition that drives the fiscal discipline result below: safety and discipline are complementary, not in tension.

Remark 4. The safety condition $t \leq t^*$ takes on additional significance in the presence of multiple equilibria. If the range of debt levels that can support a self-fulfilling crisis is wide as discussed by Blanchard (2023), then the precise calibration of t matters not only for default coverage but also for the size of the safe zone within which self-fulfilling

[4]Drawing on 200 years of data, Graf von Luckner et al. (2024) estimate an average haircut of 46%; the corresponding figure for the period 1998–2023 is 47%.

runs are impossible.[5] A threshold set firmly below t^* reduces the probability that a bad equilibrium is triggered on the eurobond tranche itself.

5 Interest Rates Without Eurobonds

Without the eurobond scheme, each country prices all its debt at a rate determined by its own credit quality. The zero-profit condition gives:

$$r(d) \;=\; \begin{cases} i & \text{if } d \le s, \\ \dfrac{1+i}{1-h\lambda(d-s)} - 1 \;\approx\; i + h\lambda(d-s) & \text{if } d > s. \end{cases} \tag{5}$$

Since all debt is repriced annually, issuing one additional unit raises the rate on the *entire* stock. The marginal borrowing cost is:

$$\mathrm{MC}(d) \;\equiv\; \frac{d[r(d)\cdot d]}{dd} \;=\; r(d) + r'(d)\cdot d \;\approx\; i + h\lambda(2d-s), \qquad d > s. \tag{6}$$

The marginal rate exceeds the average by:

$$\mathrm{MC}(d) - r(d) \;\approx\; h\lambda d, \tag{7}$$

the *infra-marginal cost*: issuing one more unit raises the rate on all d existing units. Highly indebted countries therefore face severely elevated marginal borrowing costs above and beyond their already elevated average rates.

6 Interest Rates With Eurobonds (Baseline: $\ell = 0$)

A country with $d > s > t$ issues t eurobonds at rate i and $d - t$ national bonds at rate $r^{\mathrm{N}}(d,t)$. The *effective haircut* on national bonds is:

$$h^{\mathrm{N}}(d,t) \;\equiv\; 1 - \frac{d(1-h)-t}{d-t} \;=\; \frac{hd}{d-t} \;\ge\; h. \tag{8}$$

[5] Blanchard (2023) provides an example i which multiple equilibria can arise when debt is as low as 7% of GDP.

The seniority of eurobonds concentrates all default risk onto the national bond tranche. The zero-profit condition gives:

$$\boxed{r^{\mathrm{N}}(d,t) \;=\; \frac{1+i}{1-\dfrac{hd\,\lambda(d-s)}{d-t}} - 1 \;\approx\; r(d)\cdot\frac{d}{d-t} \;>\; r(d).} \tag{9}$$

Proposition 2 (Average rate equivalence)**.** *To first order, the average interest rate is the same with and without eurobonds:* $\bar{r}^{\,\mathrm{EB}}(d) \approx r(d)$.

Proof. $i\cdot t + r^{\mathrm{N}}(d,t)(d-t) \approx it + [i + h\lambda(d-s)d/(d-t)](d-t) = id + h\lambda(d-s)d = r(d)\cdot d$. Dividing by d gives the result. □

The reform redistributes risk between tranches without, to first order, altering the aggregate cost — consistent with the observation in Blanchard and Ubide (2025) that "the average cost of funding would remain the same."

Proposition 3 (Marginal rate equivalence)**.** *To first order, the marginal interest rate is also the same with and without eurobonds:* $\mathrm{MC}^{\mathrm{EB}}(d) \approx i + h\lambda(2d-s) = \mathrm{MC}(d)$.

Proof. Total interest payments with eurobonds are

$$i\cdot t + r^{\mathrm{N}}(d,t)(d-t).$$

By Proposition 2, this equals $r(d)\cdot d$ to first order. Differentiating with respect to d gives:

$$\mathrm{MC}^{\mathrm{EB}}(d) \;\equiv\; \frac{d\big[i\cdot t + r^{\mathrm{N}}(d,t)(d-t)\big]}{dd} \;\approx\; \frac{d\big[r(d)\cdot d\big]}{dd} \;=\; r(d) + r'(d)\cdot d \;=\; \mathrm{MC}(d).$$

Substituting $r(d) \approx i + h\lambda(d-s)$ and $r'(d) = h\lambda$ yields $\mathrm{MC}^{\mathrm{EB}}(d) \approx i + h\lambda(2d-s)$, which is equation (6). □

Table 2 summarises the interest rate structure. It shows that average borrowing costs are unchanged to first order and Proposition 3 shows that marginal costs are also equivalent.

One might therefore ask what the benefit of the reform is. The key is that, while the marginal rate does not change, the relevant rate on the inframarginal stock is that of the national bonds. This is an important incentive benefit that is independent of any reduction in average costs.

Table 2: Interest Rates With and Without Eurobonds

	Without eurobonds	**With eurobonds**
Rate on eurobond tranche (amount t)	—	i
Rate on national bond tranche $(d-t)$	—	$r^{\mathrm{N}}(d,t) > r(d)$
Average rate	$r(d)$	$\approx\ r(d)$
Relevant marginal rate applies to	All d units	National bonds $(d-t)$ only

The table assumes ($d > s > t$ and $\ell = 0$)

Proposition 4 (Higher marginal cost of national debt)**.** *For a country with $d > s > t$, the rate on the marginal unit of national debt is strictly higher than the plain vanilla rate:*

$$r^{\mathrm{N}}(d,t) \;=\; r(d) \cdot \frac{d}{d-t} \;>\; r(d). \tag{10}$$

The penalty is increasing in both the eurobond threshold t and total debt d.

According to a standard critique eurobonds *weaken* fiscal discipline: the eurobond rate reflects collective rather than individual creditworthiness, so as a country's fiscal position deteriorates, the rate it pays on eurobonds rises only slowly. The eurobond scheme therefore severs the link between domestic fiscal conditions and borrowing costs.

The critique, however, conflates the *average* rate with the *marginal* rate. Fiscal discipline operates through the marginal cost of borrowing — the rate a government faces on the next unit of debt it issues. Since the eurobond tranche is a fixed, pre-committed stock, any additional borrowing takes the form of national bonds. The relevant fiscal signal is therefore $r^{\mathrm{N}}(d,t)$, not the eurobond rate. The following proposition shows that this signal is strictly *stronger* with eurobonds than without.

Proposition 5 (Higher rate elasticity on national bonds)**.** *Let $\partial r/\partial d = h\lambda$ be the sensitivity of the plain vanilla rate to the debt level. The sensitivity of the national bond rate is:*

$$\frac{\partial r^{\mathrm{N}}(d,t)}{\partial d} \;=\; h\lambda \cdot \left[1 + \frac{t(s-t)}{(d-t)^2}\right] \;>\; h\lambda \;=\; \frac{\partial r(d)}{\partial d}, \tag{11}$$

for all $t \in (0,s)$ and $d > s > t > 0$.

Proof. From $r^{\mathrm{N}}(d,t) \approx i + h\lambda(d-s)d/(d-t)$, define $\varphi(d) = (d-s)d/(d-t)$. By the

quotient rule:

$$\varphi'(d) = \frac{(d-t)^2 + t(s-t)}{(d-t)^2} = 1 + \frac{t(s-t)}{(d-t)^2}.$$

Since $s > t$ (guaranteed by $t \leq t^* < s$), the second term is strictly positive, so $\partial r^{\mathrm{N}}/\partial d = h\lambda\varphi'(d) > h\lambda = \partial r/\partial d$. □

Intuition: when a country issues one additional unit of national debt, default risk rises (as it does without eurobonds), *and* the effective haircut on national bonds rises: since eurobonds bear zero haircut in default, the entire marginal increase in expected losses falls on the national bond tranche, which is a narrower base. This amplified sensitivity drives the higher rate elasticity in (11). Again, this is a standard implication of Modigliani–Miller.

Corollary 1 (Eurobonds strengthen, not weaken, fiscal discipline)**.** *The sensitivity of the marginal borrowing cost to deteriorations in the domestic fiscal position is strictly higher under the eurobond scheme than without it (note that "marginal borrowing cost" here refers to $r^N(d,t)$, which is the rate on the next unit of national debt, not to the total marginal cost as defined in Proposition 3).*

7 Additional Benefits and Qualifications

Beyond the incentive benefit established above, Blanchard and Ubide (2025) identify a further beneficial channel. There are also qualifications related to the discussion above.

7.1 The Liquidity Premium

A sufficiently large eurobond market would drive the eurobond rate below the Bund rate. Current EU bond yields carry a spread of approximately 20 basis points over bunds, reflecting small market size and uncertainty about rollover. A market of €5 trillion would generate the depth, futures markets, repo markets, and index inclusion needed to close and reverse this spread.

If we set $\ell > 0$ in (2):

Proposition 6 (Liquidity benefit)**.** *With a liquidity premium $\ell > 0$, average and*

marginal borrowing costs fall by ℓ for every country:

$$\overline{r}^{\,\mathrm{EB}}(d) \;\approx\; r(d) - \ell, \tag{12}$$

$$\mathrm{MC}^{\mathrm{EB}}(d) \;\approx\; i - \ell + h\lambda(2d - s). \tag{13}$$

According to Blanchard and Ubide (2025) home bias and regulatory constraints (mandated allocations to domestic sovereign bonds in pension funds, for example) sustain demand for national bonds even as supply shrinks, dampening the increase in national bond rates.

7.2 Qualifications

The safety condition must hold. Proposition 5 requires $s > t$. If the threshold were set above s, eurobonds would bear positive default risk and the elasticity result could be reversed. Safety and fiscal discipline are therefore complementary. This condition is not innocuous because Blanchard (2023) shows that multiple equilibria can arise even when debt levels are as low as 7% of GDP. Blanchard and Ubide (2026) argue that eurobonds do not simply concentrate default risk onto national bonds in a static sense, they also reduces the probability of the tail events in which correlated defaults and contagion are most likely to occur. To the extent that this stabilising effect is large, the net impact on national bond risk could be smaller than a static model suggests. They claim that, to the extent that the eurobond reform makes the overall European financial system more secure, even national bond yields could end up lower than they would otherwise be.

Declining marginal discipline for highly indebted countries. While the elasticity of the national bond rate to the debt level remains strictly higher than without eurobonds for all $d > s > t$ (Proposition 5), the additional increment $t(s-t)/(d-t)^2$ is decreasing in d: as total debt rises, the extra sensitivity from eurobond seniority shrinks. Highly indebted countries therefore face a smaller additional incentive at the margin than moderately indebted ones. Two observations temper this concern. First, the inequality $\partial r^{\mathrm{N}}/\partial d > \partial r/\partial d$ holds strictly for all relevant debt levels, so the direction of the result is not affected. Second, the level of $r^{\mathrm{N}}(d,t)$ is substantially higher for highly indebted countries, so the total cost of additional borrowing remains large even if the incremental sensitivity contribution from eurobond seniority is small.

Political economy and enforcement. The result is conditional on seniority being credible. Ring-fencing VAT revenues may not withstand electoral pressure and seniority conventions lack supranational enforcement. Lustig (2025) suggests that ring-fenced revenues are most credible precisely when they are least needed: a government facing recession, rising unemployment, and an electoral cycle will face intense pressure to redirect earmarked revenues toward politically visible expenditure. Fully insulating them from legislative interference would require a strong degree of fiscal sovereignty delegation to European institutions. Blanchard and Ubide (2025) suggest that the historical record provides some reassurance. They note that Greece continued to pay its EU membership obligations despite being in default on national bonds, and that the UK honoured its Brexit financial commitments, suggesting that EU-level obligations may be more politically durable than purely domestic ones. Whether this resilience would extend to a large and recurring VAT transfer under conditions of severe fiscal stress remains an open question. A related risk is that ring-fenced transfers could become a target for nationalist mobilization, with governments portraying them as a confiscation of national tax revenues by European institutions, making them politically costly to maintain even absent a fiscal crisis. Blanchard and Ubide (2026) argue that defaulting on eurobond contributions would be tantamount to a political default on the European Union itself, a reputational and legal cost that member states have historically been unwilling to incur. They also propose that the transfer commitment be enshrined in national legislation, giving it a status comparable to existing transfers to the EU budget and thereby raising the political cost of diversion.

Institutional capture. Countries with a weak fiscal position have strong incentives to advocate for a higher eurobond threshold and to push for institutional arrangements that expand the scheme when they approach the limits of national bond market access. This is a problem of institutional capture, in which fiscally stressed countries seek to expand the scheme through political pressure at precisely the moments when the risk of mutualization is highest. Blanchard and Ubide (2026) suggest to address this problem by fixing the cap of 25 percent of GDP with explicit EU legislation, changeable only by unanimous decision. This unanimity requirement raises the threshold for any politically motivated expansion of the scheme to a level that would require the consent of fiscally conservative member states, substantially limiting the scope for institutional capture.

Dynamic considerations. The model is static and abstracts from the dynamics of rolling over the eurobond tranche. If the eurobond allocation is maintained at a fixed fraction of GDP, faster-growing countries will issue more eurobonds over time as their GDP base expands, which introduces a procyclical element: countries performing well gain a larger share of the cheaper eurobond tranche. If instead allocations are fixed at their initial levels in GDP terms, the distribution is countercyclical in the sense that countries growing more slowly retain proportionally larger access to eurobond financing. The choice of rebalancing rule is therefore not neutral and deserves attention in the institutional design of the scheme.

8 Cross-Country Implications

For countries with $d \leq t^*$, the scheme is straightforwardly beneficial: all debt is issued as eurobonds at rate $i - \ell \leq i$, so borrowing costs can only fall. For highly indebted countries ($d > s$), the average rate is unchanged to first order but falls by ℓ when a liquidity premium operates. The marginal rate on national bonds is higher than before, strengthening fiscal discipline.

The distribution of benefits across countries is uneven. For low-debt countries whose bonds already trade at the safe rate with deep liquidity, the net effect is ambiguous. The liquidity gain on the eurobond tranche is shared across the entire pool and may be small relative to the liquidity loss on the national bond tranche, which shrinks as eurobonds replace part of domestic issuance. If the relationship between market size and yield spread is sufficiently convex, so that small reductions in market depth carry disproportionately large yield costs, countries such as Germany could in principle be made marginally worse off. Whether this concern is quantitatively significant depends on the shape of the liquidity premium function around the current Bund market size, which is ultimately an empirical question.

Risk sharing is minimal: by Proposition 1, the recovery from any defaulting country always covers the eurobond tranche in full whenever $t \leq t^*$, so the guarantee from other member states is never called.

The aggregate size of the eurobond market is:

$$B \;=\; \int_m^M \min(d,t)\, f(d)\, dd \;=\; t\big[1 - F(t)\big] + \int_m^t d\, f(d)\, dd, \tag{14}$$

increasing in t. The choice of threshold involves a trade-off between safety (requiring $t \leq t^*$) and liquidity (benefiting from a larger B).

9 Conclusions

This note makes two contributions. The first is conceptual: it introduces a European debt trilemma, showing that no feasible sovereign debt architecture can simultaneously avoid mutualization, create a large safe asset, and eliminate the risk of self-fulfilling crises. The Blanchard–Ubide proposal achieves the first two objectives but does not rule out self-fulfilling dynamics. The European Debt Agency proposal of Amato et al. (2024) targets the second and third but risks reintroducing mutualization through the vulnerability of model-based pricing to political capture.

The second contribution is analytical. The model delivers three results. First, the maximum safe eurobond threshold is $t^* = s(1 - h)$, which for standard calibrations justifies the Blanchard–Ubide target of 25 percent of GDP. Second, it formally shows that the reform is neutral with respect to average borrowing costs to first order: the benefit on the eurobond tranche is exactly offset by the higher rate on the national bond tranche, a result that follows directly from Modigliani–Miller. Third, and most importantly, the reform strengthens fiscal discipline: national bonds are the only instruments issued at the margin, and their rate is strictly more sensitive to domestic fiscal conditions than the plain vanilla rate it replaces. This contradicts the claim that eurobonds decouple borrowing costs from individual fiscal behaviour; that argument conflates the average rate, which is indeed largely pooled, with the marginal rate, which is the correct signal for fiscal incentives.

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A Brief Literature Review

This note relates to two strands of the literature: the demand for safe assets and proposals for a European safe asset.

The demand for safe assets. The aggregate demand for safe assets is large and structural, driven by their roles as high-quality collateral, stores of value, and instruments for monetary policy implementation (Golec and Perotti, 2017; Krishnamurthy and Vissing-Jorgensen, 2012; Greenwood and Vissing-Jorgensen, 2018). In the eurozone, the supply of such instruments is severely limited relative to demand, and Caballero et al. (2017) document the global macroeconomic consequences of this shortage. The scarcity is compounded by the sovereign-bank doom loop, through which falling government bond prices impair bank balance sheets, contract credit supply, and thereby increase sovereign default risk (Gennaioli et al., 2014; Alogoskoufis and Langfield, 2020). The absence of a deep euro-denominated safe asset thus has systemic implications that go beyond financing costs.

Proposals for a European safe asset. The literature has explored several architectures for creating a European safe asset (see the surveys by ESRB High-Level Task Force, 2018 and Leandro and Zettelmeyer, 2019).

Delpla and von Weizsäcker (2010) propose dividing each member state's sovereign debt into two tranches. The senior tranche, called blue bonds, would cover debt up to 60 percent of GDP and would be jointly issued by all eurozone member states with joint liability, making them a genuinely safe European asset. The junior tranche, called red bonds, would cover any debt above 60 percent of GDP and would be issued individually by each country, bearing the full concentrated default risk. The subordination of red bonds to blue bonds would make red bond yields highly sensitive to national fiscal conditions, thereby preserving market discipline.

The proposal by Blanchard and Ubide (2025) builds on Delpla and von Weizsäcker (2010) but dispenses with the joint and several guarantee that makes the blue bond design an instance of debt mutualization. Rather than making all member states legally obligated to cover one another's obligations in the event of default, the Blanchard–Ubide proposal requires each country to make a legal commitment to transfer a dedicated stream of tax revenues, approximately 1 percent of GDP, exclusively to service its own eurobond tranche. Each country backs only its own obligations; no country is

liable for another's. Safety is achieved through the ring-fencing of a revenue stream, not through mutual insurance.

Juncker and Tremonti (2010) propose the issuance of European bonds, or e-bonds, by a European Debt Agency funded by member state contributions proportional to their GDP. The agency would issue e-bonds on behalf of member states up to a limit of 40 percent of GDP per country, with proceeds on-lent to governments at the agency's borrowing rate plus a small spread. Debt above the 40 percent threshold would continue to be issued nationally and subject to market discipline.

Recently Hildebrand et al. (2026) proposed the issuance of European Future of Defence Bonds, jointly backed by a coalition of willing member states, to finance a common European defence architecture. Their proposal involves joint and several liability and is thus close to the Delpla and von Weizsäcker (2010) blue bond design, but reflects the logic that European strategic autonomy requires a large and liquid common debt market. Lane (2026) explicitly endorsed expanding the supply of euro safe assets. Lane emphasises that an expansion of common debt increases rather than reduces the importance of fiscal discipline at the national level, a conclusion consistent with the main analytical result of this note. Support has also emerged from the Bundesbank (Nagel, 2026) and from EU finance ministers (Cuerpo, 2026).

Brunnermeier et al. (2011) and Brunnermeier et al. (2017) propose European Safe Bonds, or ESBies, as a market-based mechanism for creating a safe European asset without debt mutualization or joint guarantees. A financial intermediary, envisaged as a European Debt Agency or a private entity, would purchase a diversified portfolio of eurozone sovereign bonds, weighting each country according to its GDP share. Against this portfolio, the intermediary would issue two tranches of securities. The senior tranche, the ESBies themselves, would absorb losses only after the junior tranche is fully wiped out, giving them a high degree of safety through diversification and subordination. The junior tranche, the European Junior Bonds, would concentrate all residual default risk and trade at a significant discount. Because no joint guarantee is involved, mutualization is avoided. The principal criticism is the juniority problem: in a systemic crisis affecting multiple sovereigns simultaneously, diversification offers limited protection, the junior tranche could be rapidly depleted, and the safety of the senior tranche could be compromised. A feasibility study by the European Systemic Risk Board (ESRB High-Level Task Force, 2018) concluded that ESBies were technically viable but that the systemic risk concern required careful attention.

The European Debt Agency (EDA) proposal of Amato et al. (2024) seeks to resolve the impossible trinity highlighted in this note by issuing traded bonds on capital markets and on-lending the proceeds to member states through perpetual loans priced according to a fundamentals-based formula differentiated by country creditworthiness. Because pricing is idiosyncratic rather than pooled, the authors argue that no mutualization arises, while the traded EDA bonds constitute a new safe asset. By anchoring sovereign financing costs to fundamentals, the mechanism also aims to reduce the rollover risk associated with market sentiment-driven spread volatility. The main issue with this proposal is its reliance on model-based pricing which introduces a vulnerability: if the pricing formula can be influenced or if model uncertainty is exploited, the differentiation across member states could be compressed, reintroducing mutualization implicitly.