THE ROAD TO A COMMON EURO AREA DEBT ISSUANCE MECHANISM

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*The views expressed in this presentation are those of the presenter and do not necessarily represent those of Bruegel. This presentation draws on an extensive litterature review and joint workshops with the IMF and the EBRD.

Summary

1. The context: Imperfect safety nets and the two pack debate
2. Why eurobonds?
3. The different proposals
   a. Economic
   b. Financial
   c. Institutional
   d. Political
4. A possible path

What for?

Bank-Sovereign Loop	-home bias in sovereign debt holdings remained and has deepened. It increases the vicious links between banks and their respective sovereign -LTRO has increased this phenomenon and therefore increased systemic risk
Provision of a safe asset	-when sovereign risk emerge, sudden contraction in the supply of riskfree asset creates destabilizing capital movements for banks and for countries -shortage of riskfree asset globally has consequences for global imbalances
Fiscal discipline	-SGP and surveillance enforced by sanctions has showed its limits -fiscal common good in Europe is limited in size (EU budget) and common debt issuance could be a device to introduce fiscal discipline
Fiscal Risk sharing	-monetary union imposes sharing of risks and costs linked to managing a monetary union -this involves a degree of fiscal transfers
Monetary Transmission Mechanism	-monetary policy transmission mechanism are impaired by financial instability -natural vehicle to transmit single monetary policy is large and deep single sovereign bond market
Reduction in borrowing cost	-originally an important motivation for issuing debt jointly and reducing borrowing cost at the aggregate level -linked to the liquidity benefits of the euro area as reserve currency

The different proposals

Proposals

Eurobills	Thomas Philippon (NYU) Christian Hellwig (Toulouse)	-joint and several issuance of debt limited to short term debt -would limit guarantees to about 10% of GDP
Debt Redemption Pact	German Council of Economic Experts (Sachverständigenrat)	-creation of a fund for the amortization of all the debt in excess of 60% of GDP (≈2.3trillion euros) -designed to accelerate consolidation over the next 20yrs
Blue Bond-Red Bond	Jacques Delpla Jakob von Weizsäcker (Bruegel)	-debt below 60% could be issued jointly and severally -debt markets would be split in very senior and very junior red debt
Stability Bonds	European Commission	-Partial or total joint and several issuance of debt -EDPS would allow Commission/Council to set price of blue debt for each country
European Safe Bonds (ESBies)	Euronomics Group Brunnermeier (Princeton) Garicano (LSE), Lane (Trinity)…	-transformation of existing stock of debt in two categories a junior and a senior -immediate reduction in flight to quality

Comparative analysis

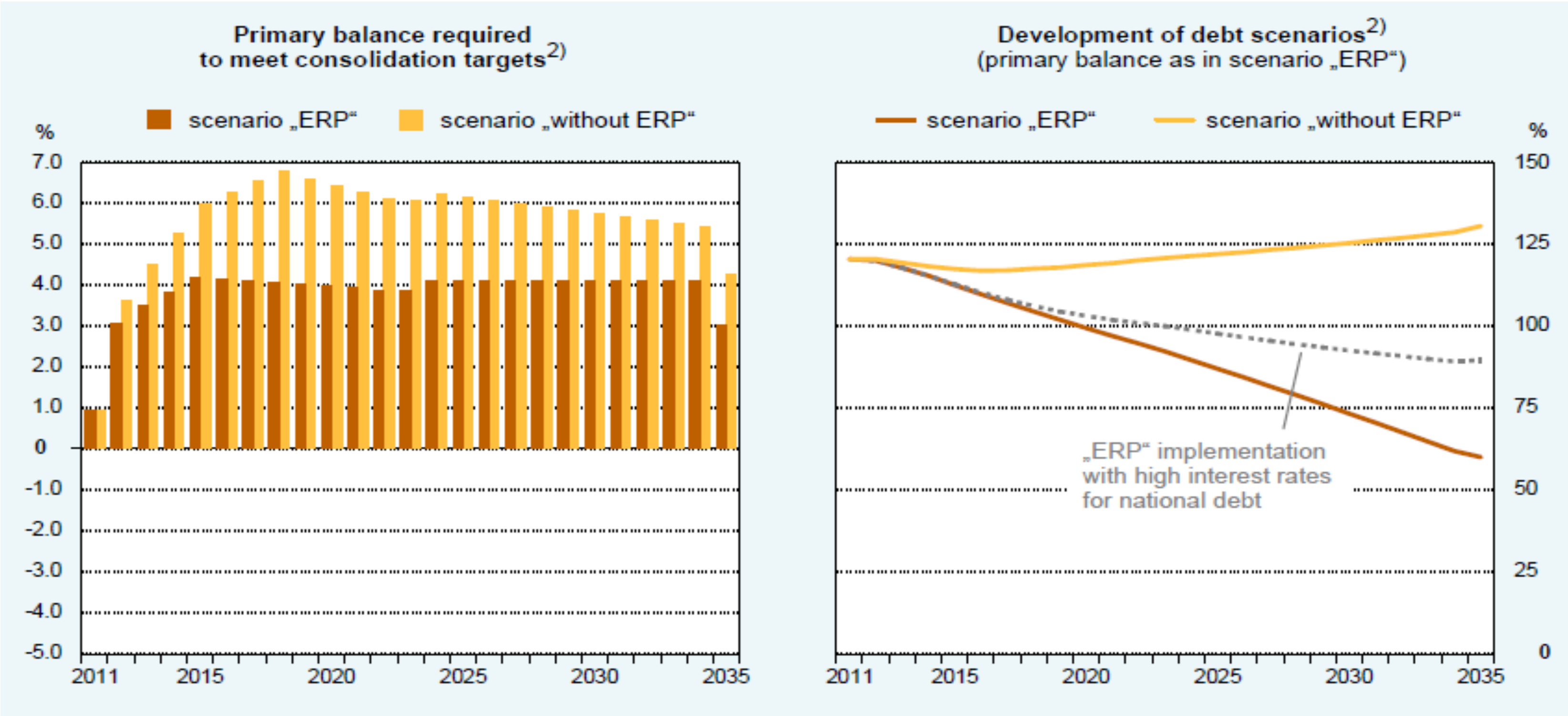
Economics – Size and Scope

Economics	Eurobills	Blue Bond- Red Bond	Debt Redemption Fund	Stability Bonds	ESBies
Type of Guarantee	Joint&Several	Joint&Several for Blue, Junior and National for Red	Joint&Several + Several	Joint&Several	No
Limit to issuance	≈10% of GDP but expandable	Up to 60%	Whole stock above 60% of GDP	Not clear	Up to 60% of GDP
Borrowing Cost	Lower on bills and on average	Lower on blue but probably higher on red, average lower but depends on total stock of debt	Lower on average	Depending on size	No

Economics – Fiscal

Economics	Eurobills	Blue Bond- Red Bond	Debt Redemption Fund	Stability Bonds	ESBies
Fiscal Coordination	No	Committee tor allocation of blue	High degree of coordination needed, for allocation and convergence path		No
Fiscal Risk sharing	Limited to the size of the issuance	Potentially large (up to 60% of GDP)	Limited	Depends on size could be largest if total joint issuance	No
Fiscal discipline	Market discipline for debt outside of eurobills	Market discipline for red debt	Earmarking of revenues and precedence of ERF repayment	Fiscal Compact + potential earmarking of revenues	No

Italy under the European Redemption Fund



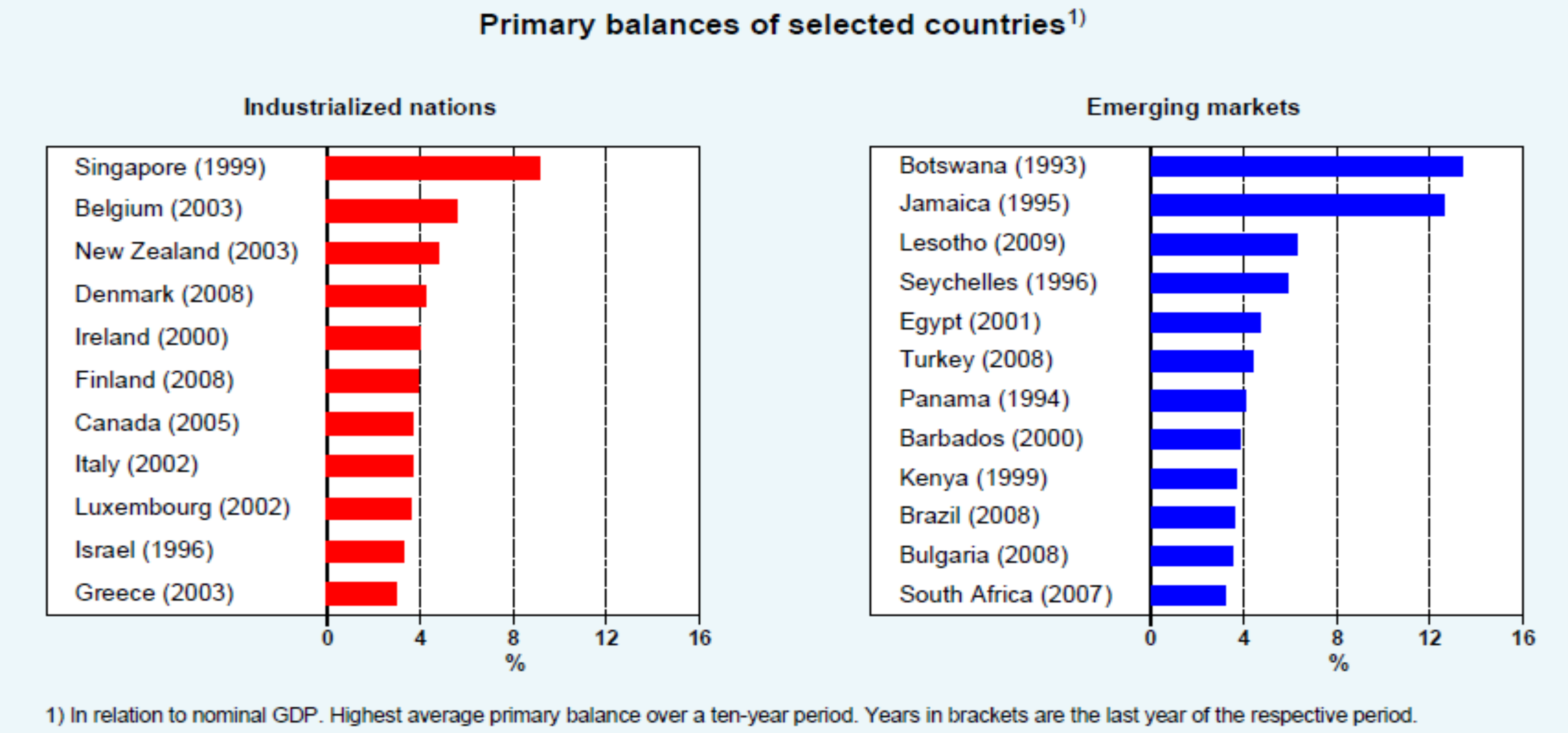
Key Assumptions:

•1,95% nominal GDP growth in 2012, 3% thereafter

•Interest rate of national debt 5% (7% for negative scenario)

•Interest Rate ERP 4% and yearly payment to ERP amount to 3,1% of GDP

Primary Balances



- •Only 3 advanced economies ever achieved a primary surplus in excess of 4% of GDP for more than 10 years
- •Only 6 emerging economies ever achieved a primary surplus in excess of 4% of GDP for more than 10 years

Economics – Financial Stability

Economics	Eurobills	Blue Bond-Red Bond	Debt Redemption Fund	Stability Bonds	ESBies
Sov-Bank link	Key objective	Key objective	Immediate effect but temporary	Limited objective	Major objective
Flight to safety	Less flight to safety	Less flight to safety	Potentially remains	Less flight to safety	Reduced and concentrated on tranches of risk
Multiple equilibria	Limited scope for multiple equilibria	Red debt's cost might be excessive, depends on allocation	Contingent on stabilization path	Depends on scope	Possible for new issuance

Financial

Finanicial	Eurobills	Blue Bond- Red Bond	Debt Redemption Fund	Stability Bonds	ESBies
Primary / Secondary	primary				secondary
Infrastructure	Central DMO + National DMO	Central DMO + National DMO	Fund + National DMO	Depends	New European Debt Agency but no DMO
Price Effect	Limited	New Seniority could mean important changes			Limited

Institutional / Legal

Institutional	Eurobills	Blue Bond- Red Bond	Debt Redemption Fund	Stability Bonds	ESBies
Treaty Change	Not necessary	Probable	Not necessary	Probable	Not necessary
German Constitution Change	Not necessary	Probable	Not necessary	Probable	Not necessary

Two essential challenges:

1. EU law and the constraints imposed by the current Treaty and in particular
    a. Art. 125 in principle constrains but (Opinion from the Council vs Commission)
    b. the recently amended Art. 136 gives some leeway for crisis resolution and financial assistance
    c. Art. 352 is another avenue but requires unanimity
2. German Basic Law and the German Constitutional Court
    a. Preamble and Art. 23 make Federal State possible in principle
    b. Caveat of ruling on the Lisbon Treaty and on EFSF
    - No automatism / No permanent guarantee

Political

Political	Eurobills	Blue Bond- Red Bond	Debt Redemption Fund	Stability Bonds	ESBies
Countries	Could phase in but needs Core	Could phase in but needs Core	All countries with debt > 60% of GDP	Could phase in but needs Core	Could be variable geometry
Accountability	Limited need	EP to vote	Not discussed	TBD depending on option	Limited need
Exit	Easy exit (no renewal of Tbills issued)	Difficult	No exit until has converged to 60% of GDP	Difficult	No exit once transacted
Lead time	Short	Long	Moderate	Moderate to Long	Short

Possible path

A possible path

Political commitment

- after 6 pack, fiscal compact and two pack, MS should make political commitment towards a form of fiscal union
- Most of the hard decisions are included in these governance change allow for it

Eurobills / Project Bonds

- European Council should order a report on the feasibility of common debt issuance with two pilot schemes in mind:
    - Eurobills: to finance national budgets
    - Project bonds: to finance European projects

Eurobills to eurobonds

- Review of the experience should allow to gradually extend maturity and scope of pilot towards blue bond / red bond proposal
- Modification of ESM Treaty to turn it into European Treasury

Ministry of Finance

- Greater Executive authority of the eurogroup with greater accountability of its president before the European parliament and national parliaments
- Ideally, president of eurogroup=president of commission and is elected by EP